Economic Policy Institute

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Why U.S. Manufacturing Needs A "Strategic Pause" in Trade Policy

Testimony of Jeff Faux
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Before the United States Senate
Committee on Commerce, Science, and Transportation
hearing on the
Current State of American Manufacturing Industries

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Trade and Manufacturing

Over the last 10 months employment in U.S. manufacturing has shrunk by 675,000 jobs. If this were simply the temporary result of a business cycle downturn, it would be a serious problem.

But as **Figure 1** shows, job loss in manufacturing is a trend of two decades. It reflects the deterioration in the American industrial base, which has now reached crisis proportions.

Why does it matter? For several reasons:

- Manufacturing is the overwhelming source of productivity improvements and technological innovation in the U.S. economy. If manufacturing were removed from the national productivity numbers, America would be left with a largely stagnant economy.

- Manufacturing is the traditional ladder of upward mobility for non-college graduates, who still make up the majority of U.S. workers. It provides the high wage jobs that can lift people into the middle class. It is also a traditional means for immigrants to assimilate into the economy.

- It is critical for the diffusion of innovation. Without a healthy steel industry, for example, the U.S. auto and aerospace industries would be laggards in the competitive race to produce new products with the next generation of lightweight metals.

- A strong industrial base has been essential for national defense throughout history.

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There is, of course, a tendency in most advanced countries for manufacturing to decline as a *share* of total employment over the long term. This is largely a result of the higher productivity rates in manufacturing relative to the service and commercial sectors. But there is no immutable evolutionary economic law that predicts the *absolute* decline in manufacturing jobs that we see in America today.

A major reason for that absolute decline can be observed in **Figure 2**, which shows America's current account deficit and the trade deficit in manufacturing goods. It mirrors the decline in manufacturing employment over the last two decades. The crisis in manufacturing is directly related to the long-term erosion of the U.S. trade balance.

But the debate over trade policy still reflects the triumph of ideology over experience. The facts are clear: the trade deficit has done major damage to the industrial core of the economy. And it is common sense that a nation cannot forever continue to buy more than it sells in the global market. Yet U.S. policymakers from both parties remain sublimely indifferent to America's trade deficit and corresponding deficit on the current account, which in 2000 was 4.4% of GDP.

To a large extent, the problem of the trade deficit has been hidden in recent years by the remarkable growth of the domestic U.S. economy since 1992. Imagine that the U.S. economy is a company with two divisions – a large "domestic" division and a smaller "foreign" one. During most of the 1990s, the domestic division was extremely profitable, obscuring the fact that the foreign division was losing money. **Table 1** illustrates the point. From 1992 to 2000, real gross domestic product grew by $2.4 trillion, adding 23 million jobs to the economy. But a continued deficit in the international sector of the economy cost 3.8 million jobs.

As long as the U.S. domestic economy grows rapidly, many have argued, workers who lost their jobs as a result of the trade deficit will be rehired in the domestic-oriented economy. However, such transitions are not easy for real people dealing with the real world. In fact, even in boom times, the average worker laid off in manufacturing did not obtain a new job comparable in wages and benefits to his or her old one.

We now know that the extraordinarily high rate of domestic growth in the last half of the 1990s – driven in large part by a speculative bubble in the stock market – was unsustainable. The unemployment rate has been on a rising trend since last October. Despite a minor dip in May 2001, an overwhelming majority of forecasters expect it to continue to increase in the coming months, revealing the ongoing crisis in our industrial sector.

Figure 3 shows the 12 sectors that accounted for almost 90% of the trade deficit last year. Led by autos and parts, 10 of the 12 are manufacturing industries, and the other two represent oil, natural gas, and petroleum products. The "new economy" sectors of audio and video equipment, semi-conductors, computers, and communications equipment are among the "losers" from U.S. foreign trade.

Table 2 shows the major countries with whom America is running trade deficits. The huge and rapidly growing deficit with China is particularly troublesome, in light of the eagerness of this Administration, like the last one, to enlarge our trade with that nation. The North American Free Trade Agreement and the Free Trade Agreement with Canada were both sold to the Congress as a way of *reducing* the U.S. trade deficit. Instead the opposite happened; trade deficits with both economies grew. In the case of NAFTA, it was specifically argued that the trade deal would result in a massive U.S. surplus because of all the autos Detroit would sell to Mexican consumers. Instead, U.S. companies outsourced to Mexico to take advantage of cheaper labor and sold cars and parts back here.

The impact of the trade deficit on American workers surpasses the issue of jobs. As **Figure 4** shows, the long-term stagnation in workers' earnings stems from the mid-1970s – the time when America's trade balance in goods began to go into chronic deficit.

Trade deficits are not the only contributors to the real wage difficulties of U.S. workers. Conventional models of wage behavior show that imports account for about 20-25 percent of the wage decline. However, these same models can only identify specific causes for about half of the decline in real wages. Thus, the trade deficit probably accounts for at least 40% of the identifiable causes.

Moreover, there is ample evidence that trade deficits are having negative effects on wages unnoticed by standard economic models. Kate Broffenbrenner, a Cornell University economist, has shown how NAFTA has given credibility to employer threats that their firms would close down and move to Mexico if employees voted for a union to improve their wages and benefits.

It is also important to note that the evidence to date supports the claim that the current type of trade agreements have encouraged a "race to the bottom" as far as wages are concerned. For example, a recent study, *NAFTA at Seven*, written by economists from Canada, Mexico and the United States showed that deregulation has pushed down wage levels in all three countries. I would like to submit that study for the record.

In assessing the relationship of the trade balance and manufacturing, I would also call your attention to **Figure 5**. Trade deficits do not come free. In order to finance them, the United States must either borrow money or sell our assets. The net U.S. foreign debt represents the transfer of claims on U.S. wealth with which we are financing the deficit. As a result of accumulated trade deficits, the debt is now close to 20% of GDP. Unless the current trade deficit trend is reversed, this figure will grow relentlessly, and could easily reach 60% of GDP in another eight years.

So far, the use of the U.S. dollar as reserve currency for the rest of the world and the sense that the United States is a safe haven in a volatile global market have protected the United States from a precipitous decline in the dollar's value. Such a decline could set off a financial crisis that would dwarf the 1997 Asia currency debacle. But the debt sword of Damocles is hanging by a thinner and thinner string. The United States cannot borrow and sell assets forever. Eventually, the United States will be forced to run a trade surplus, or face a Depression-level shrinkage in the economy. In order to run a surplus, the United States will need a strong – and much larger – manufacturing base. Yet, this administration – like the last one – is indifferent to both the piling up of foreign debt and the eroding of manufacturing.

Contrast the attitude toward the foreign *trade* deficit with the national anxiety over the government's *fiscal* deficit. When the Federal deficit reached the vicinity of 4% of GDP a decade ago, there was much handwringing and national panic over the debt that might be left for the next generations. The concern became so strong that it has now become politically impossible for the U.S. government to borrow money to make capital investments in infrastructure. However, the danger of the foreign current account deficit is arguably greater. By and large, federal deficits are owed to ourselves. In contrast, and by definition, the dollar liabilities generated by the trade deficit represent foreign claims on American incomes, which will be much more painful for our children to pay. Absent a large and healthy manufacturing base, they will not be able to do it without a dramatic drop in their living standards.

Causes of the trade deficit problem

Temporary factors. In the last few years, the chronic trade deficit has been worsened by two factors. First, and most recently, oil and natural gas prices have increased, which has raised the cost of energy imports. Second, there has been faster growth in demand in the United States relative to its major trading partners, particularly after 1997, when the Asia currency crisis slowed down the demand for U.S. exports and led to a large inflow of short-term capital that financed a faster growth in demand for imports.

Fundamental problems. The trade deficit has been growing for two decades, a time that has included periods of low oil prices and periods of slower relative U.S. growth. The more basic causes of a chronic long-term imbalance are largely due to the following:

> *Shortsighted trade policies.* During the Cold War, trade policy was largely an extension of foreign policy. Pieces of the lucrative U.S. market were parceled out or withheld from foreign countries as a carrot or stick to gain allies against the Soviet Union and its communist allies. After the end of the Soviet Union, the deregulation of trade became an end unto itself, rather than a means to achieve U.S. prosperity. Rationalized by the illusion that free trade amounted to a free lunch, successive U.S. governments have led the nation into trade agreements that have reflected the interests of multinational investors at the expense of companies that produce in the United States and their workers and families. As a result, many of the so-called "free trade" agreements, such as NAFTA, are as much or more concerned with protecting investment as they are with trade.

Lack of manufacturing policy. Unlike most other nations, the United States has no active policy to preserve its manufacturing base. Since trade largely involves the industrial sector, there is no policy framework to guide the deals made by the U.S. trade negotiators. The result is that American trade negotiators have a tendency to see expanded trade – whether imports or exports – as an end unto itself, rather than as a means to a healthy American economy.

Lack of international labor and environmental standards. All advanced modern economies contain enforceable rules for the protection of labor and human rights and the maintenance of environmental standards. These economic rights assure that the benefits of economic growth will be widely shared and that growth will not jeopardize the air we breathe and the water we drink. But the global economy has no such protections. This has encouraged multinational corporations to shift production to locations in the Third World where labor and human rights and environmental standards either do not exist or are not enforced. This puts U.S. workers at a disadvantage and prevents development in the Third World from raising wages there.

Foreign protectionism For all the complaints about U.S. protectionism, the U.S. market is far more open than the domestic markets of its trading partners. The much greater transparency of the U.S. legal and political system puts America at a disadvantage relative to the European Union and Japan, whose economies are laced with formal and informal non-tariff barriers to the U.S. goods.

Overvalued dollar. Normally, a national economy adjusts to a prolonged trade deficit by having its currency decline in value, making its exports more expensive and its imports cheaper. The U.S. dollar has not fallen in order to allow that adjustment to take place. One reason is the policy of the U.S. government to resist a drop in the dollar's value. This bias favors U.S. investors in foreign nations – whose interest is to have a more valuable dollar – over U.S. producers in America, who need a lower dollar in order to expand exports. Estimates vary, but currently the U.S. dollar is overvalued by at least 25% percent, and possibly as much as 40%.

Low savings. A low savings rate means a reliance on foreign sources of investment. Ultimately, net financial inflows create spending on foreign goods and services. Low savings also means high consumption. As a result of these factors, American consumers have an extraordinary high marginal propensity to consume imports. Currently, however fast the U.S. economy might grow, imports grow faster.

Policy considerations

The crisis in manufacturing employment will not be resolved by a single policy bullet. It will require a range of policy solutions, guided by an understanding of the fundamental causes of the problem. The process must start with a commitment to restoring and maintaining the U.S. industrial base.

The basic issue is not how to placate a politically important industry or constituency. Instead, America needs to ask if it wants to have an industrial base 10-20 years from now. If so, how does the United States assure that it will have one?

It has been a long time since the United States asked itself such strategic questions about the economy. In fact, the United States has largely abandoned the institutions and habits of thought that are involved in coming up with answers.

Therefore, if America is serious, it needs to provide the time necessary for a meaningful policy debate. To give us that time, I suggest that we need:

- A "*strategic pause*" in the relentless pursuit of trade agreements, such as another World Trade Organization (WTO) round or the proposed extension of NAFTA to the rest of the Western Hemisphere in a so-called Free Trade Area of the Americas. In the last decade alone, the United States has signed over 200 trade agreements, yet done virtually no serious evaluation of their impact. Despite this real life experience, the debate over trade and globalization in America is still as dominated by ideology, assertions, and theorizing as it was two decades ago. It is time to find out what we have learned and debate its implications.

- Meaningful short-term efforts to protect industries such as steel, while are now faced with virtual extinction as a result of the destructive trade policies of the last two decades. Without such efforts, there will be little industrial base to preserve.

In terms of specific policies that might help halt and even reverse the erosion of the U.S. manufacturing base, I recommend the following be considered:

1. A national commitment to strengthening the manufacturing sector in the U.S. economy. This would include:
    - Increased research and development subsidies
    - Creation of a capital pool for small- and medium-sized U.S. manufacturers
    - Large increases in technical training and career-long education for American workers.

2. An expansion of manufacturing competitiveness would also help resolve the savings shortfall. We really do not have credible strategies for raising the

consumer savings rate, nor should we try. But some profits for U.S. producers would lead to higher rates of internal corporate savings and reinvestment.

3. Insistence on giving the establishment and enforcement of labor rights and environmental standards parity with the enforcement of investor and commercial rights in trade agreements.

4. A commitment to a gradual lowering of the value of the dollar.

5. The rekindling of economic growth in Europe and Japan as the central goal of our policy toward these critical partners. The United States simply can no longer maintain the burden of being the engine of economic growth for the world.

6. A national long-term energy strategy that reduces reliance on imported energy.

7. A reorganization of the trade policy apparatus. Today, that apparatus is dominated by the U.S. Trade Representative, a “deal-making” agency in which getting new agreements is the highest priority. The USTR should be totally revamped or removed from cabinet status and subordinated to a cabinet agency whose purpose is to define an agenda for improving U.S. competitiveness in order to enhance U.S. living standards.

Unfortunately, the Bush Administration, like the Clinton Administration before it, is moving down the same path that has created this large and unsustainable trade deficit, in which the price of marginally cheaper consumer goods is a vanishing industrial base. The demand for “fast-track” authority, the rush to expand NAFTA to the entire Western Hemisphere, and the encouragement of yet another WTO round should be suspended. We need a Strategic Pause in trade policy while America evaluates the lessons of the extraordinary expansion of trade agreements. These agreements are accumulating a massive international debt at the same time that the United States is abandoning the only economic sector – manufacturing – that provides the means to pay it down.

Table 1

Sources of job gains and losses, 1992-2000

	Growth in real GDP (billions $1996)	Jobs gained or lost
International trade		
Exports	474	4,523,986
Imports	-868	-8,279,982
Net exports	-394	-3,755,996
Consumer spending	1,691	16,127,791
Private domestic investment	940	8,967,834
Government spending	169	1,607,532
Total gross domestic product	2,427	23,158,000

Source: U.S. Department of Commerce, Bureau of Labor Statistics and EPI. Note: Statistical residual not reported.

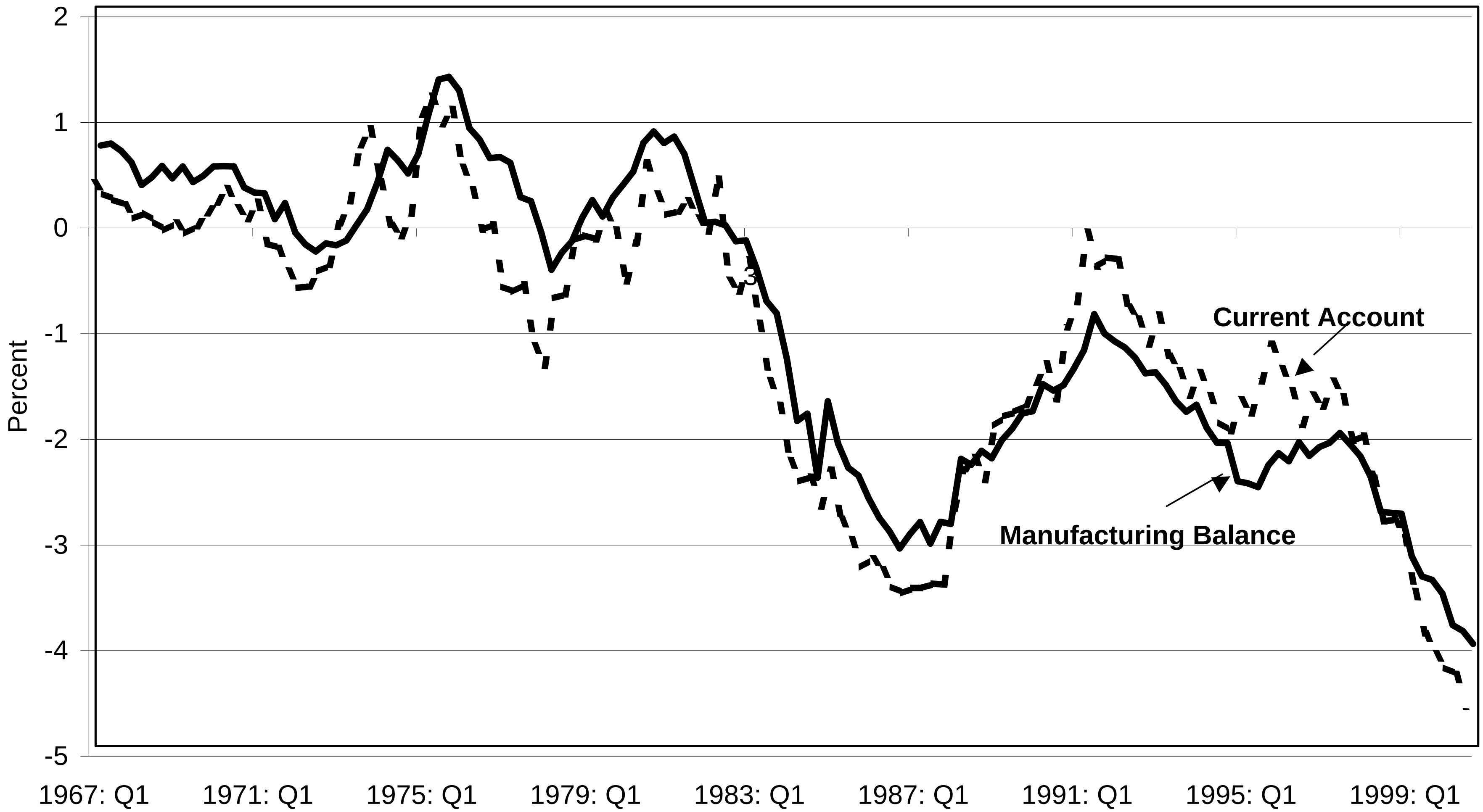
Table 2

US balance of goods trade by selected areas and countries, 1998 and 1999, year-to-date (millions of dollars)			
	1999	**2000**	**Percent change**
Total Balance of Payments Basis	-345,559	-449,468	30%
Net Adjustments	-16,738	-15,154	-9%
Total Census Basis	-328,821	-434,314	32%
NAFTA	-54,923	-74,613	36%
Canada	-32,111	-50,423	57%
Mexico	-22,812	-24,190	6%
Western Europe	-47,018	-59,761	27%
Euro Area (2)	-38,069	-47,780	26%
European Union	-43,413	-55,541	28%
Pacific Rim Countries	-185,969	-214,942	16%
China	-68,677	-83,810	22%
Japan	-73,398	-81,322	11%
Newly Industralized Countries(NICS)	-24,113	-26,729	11%
Hong Kong	2,124	3,173	49%
Korea	-8,220	-12,398	51%
Singapore	-1,944	-1,370	-30%
Taiwan	-16,073	-16,134	0%
Other Pacific Rim(3)	-26,319	-29,102	11%
South/Central America	-3,312	-14,043	324%
OPEC	-21,812	-47,793	119%
Indonesia(3)	-7,487	-7,839	5%
Nigeria	-3,757	-9,830	162%
Saudia Arabia	-342	-7,989	2236%
Venezuela(3)	-5,981	-13,096	119%
Other OPEC	-4,245	-9,039	113%

Source: Economic Policy Institute and The U.S. Census Bureau, FT900 -- U.S. International Trade in Goods and Services, December 2000:http://www.census.gov/foreign-trade/www/press.html.

Figure 1

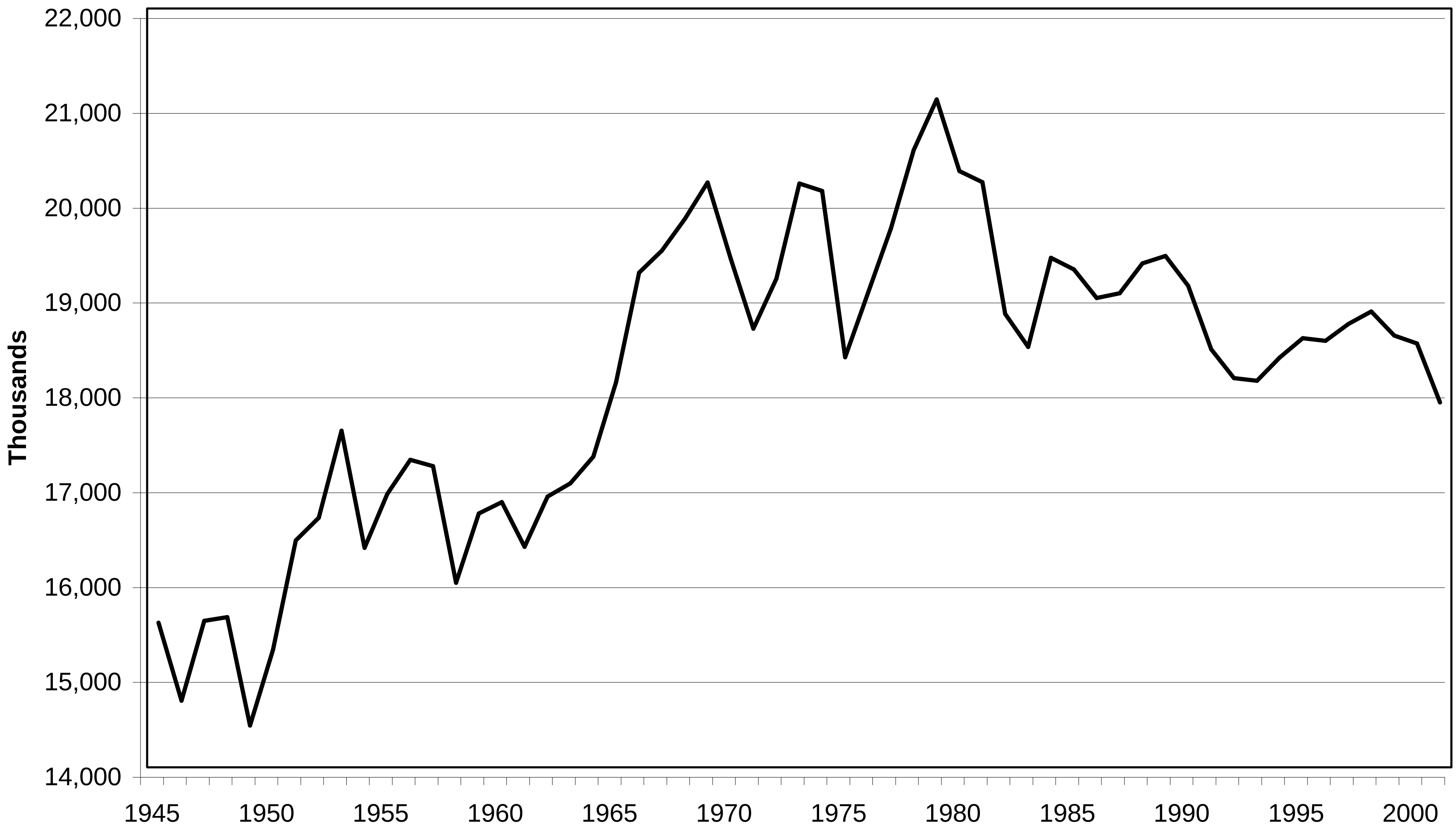
Current account and manufacturing trade balance as a share of GDP; 1967 through the third quarter of 2000



Source: U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts (quarterly), and analysis by Wynne Godley of the Levy Institute.

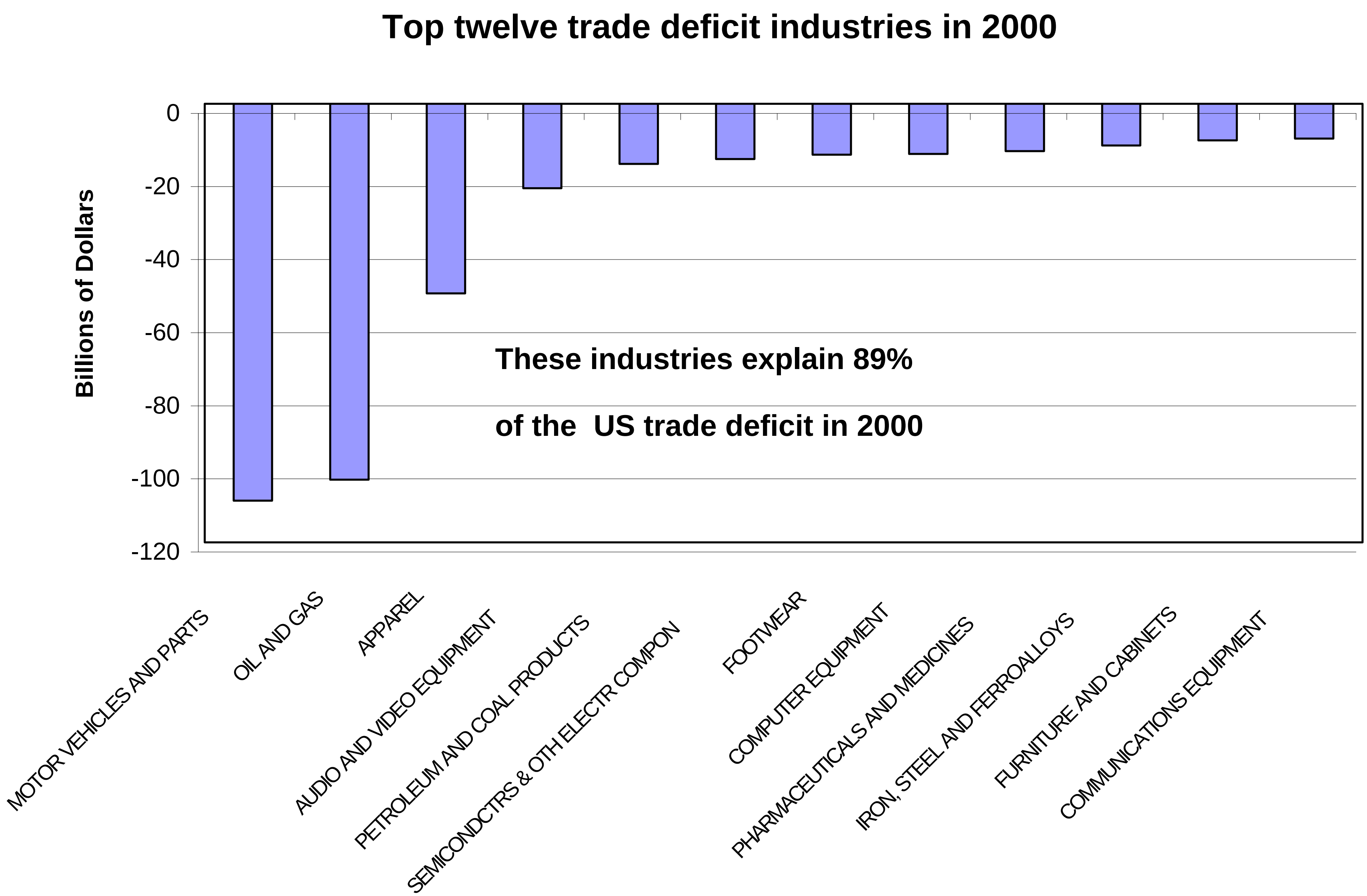
Figure 2

U.S. manufacturing employment in the Post-War era



Source: Economic Policy Institute and The U.S. Census Bureau, FT900 -- U.S. International Trade in Goods and Services, December 2000: http://www.census.gov/foreign-trade/www/press.html.

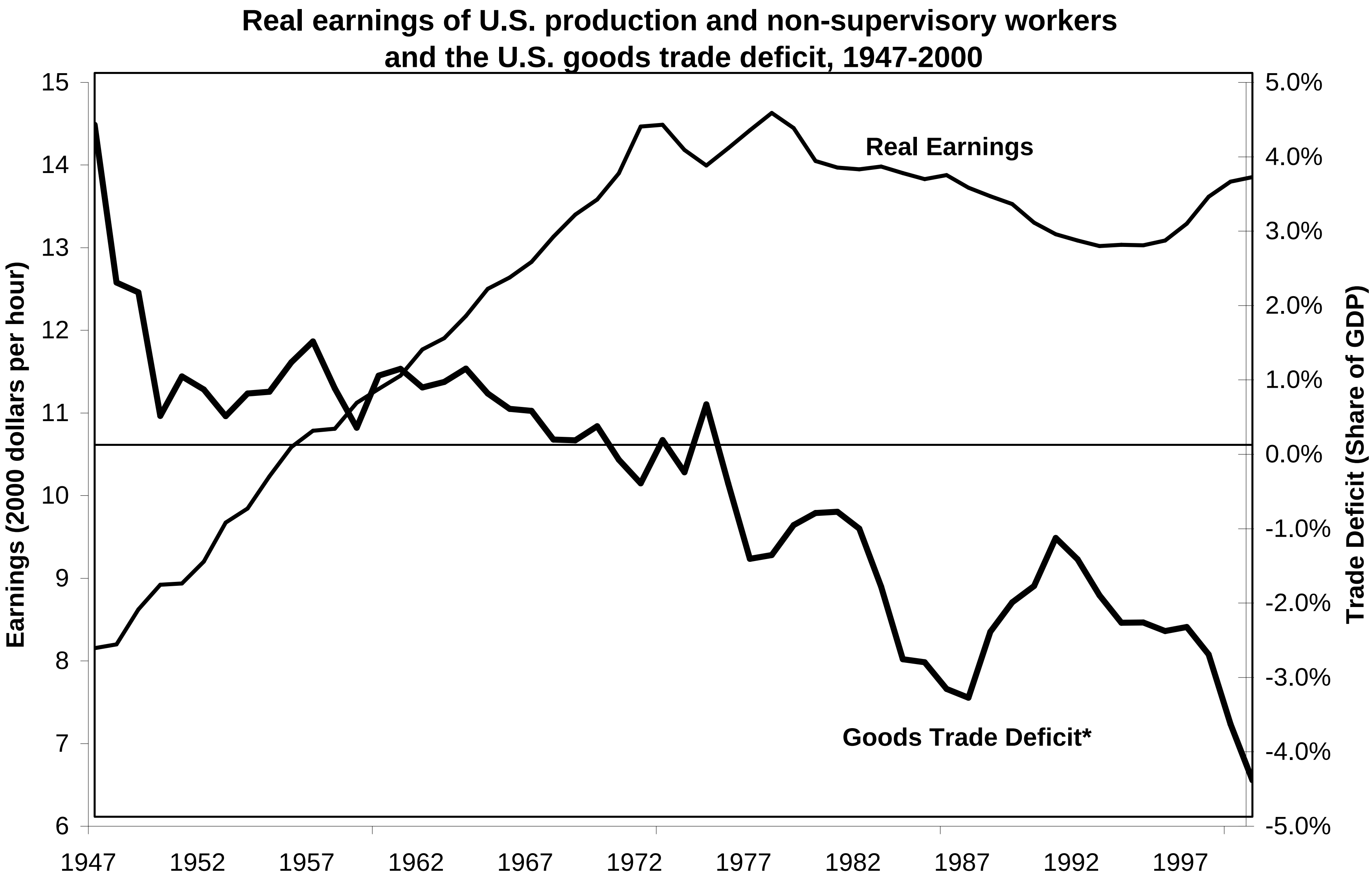
Figure 3



Notes: Four-digit NAICS Product Groups, Miscellaneous products excluded (industries 3800 and 3900), Motor vehicles and parts sectors combined.

Source: EPI and U.S. Department of Commerce, "US Foreign Trade Highlights," http://www.ita.doc.gov/td/industry/otea/usfth/tabcon.html

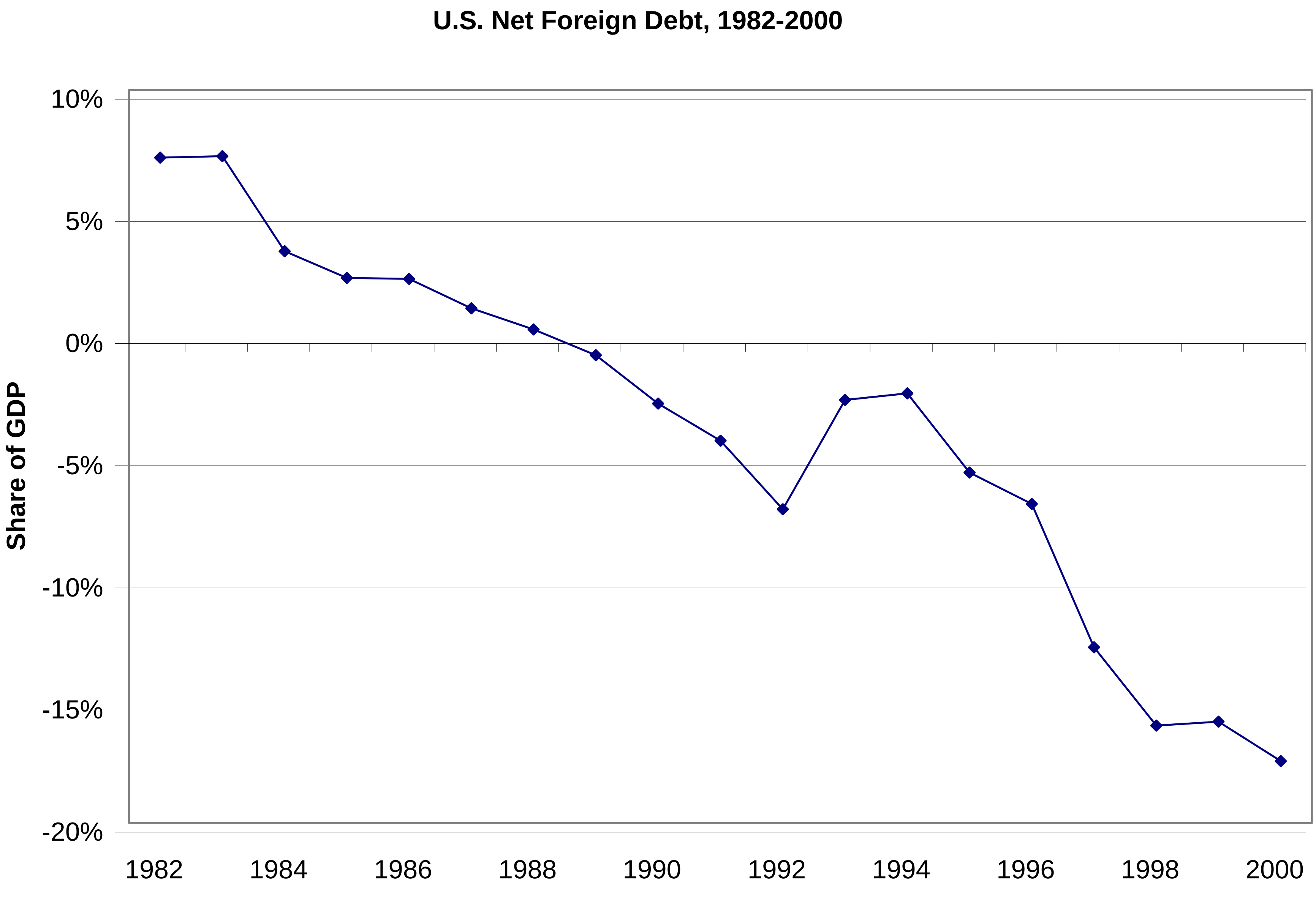
Figure 4



*Goods Trade Deficit as a share of GDP

Source: Economic Policy Institute analysis of data from the Census Bureau and the BLS.

Figure 5



Sources: Bureau of Economics, International Transactions reports at: http://www.bea.doc.gov/.