Testimony presented by Economic Policy Institute senior international economist Robert E. Scott before the U.S. House Committee on Small Business on Wednesday, April 26, 2006.

Mr. Chairman and members of the Committee, thank you for inviting me to testify today. My name is Robert E. Scott and I am a senior international economist for the Economic Policy Institute here in Washington.

U.S. export performance has steadily declined for more than two decades. U.S. export promotion strategies are flawed and ineffective because they build on a faulty understanding of the causes of weak export growth. Small and large businesses in the United States are confronted by a number of fundamental export barriers, including:

- Sustained overvaluation of the dollar since 1995 that has been aided and abetted by a passive and non-interventionist response from responsible officials in the White House and Treasury
- Persistent tariff and non-tariff barriers to U.S. exports
- Highly unbalanced trade flows with some countries, especially China (U.S. imports from China were six times the level of exports to that country)
- High and rapidly growing benefit costs for U.S. workers, especially for health care
- Low levels of federal R&D support

U.S. export promotion plans and activities, as set forth in the Trade Policy Promotion Committee's (TPPC) 2005 National Export Strategy, fail to directly address these fundamental problems.[1]

Past experience has demonstrated that changes in government policy can dramatically increase the growth in exports and slow the growth of imports, allowing domestic producers to recapture market shares at home and abroad. The following are examples of the types of policy responses that are needed from particular TPPC agencies:

- The U.S. Treasury should admit that China is preventing its currency from rising to the appropriate value (currency manipulation) in its semi-annual exchange rate report, and begin negotiations with China leading to termination of these practices
- Work with other members of the G-8 to develop a concrete plan for bringing about a substantial and sustain reduction in the value of the U.S. dollar of at least an additional 30% to 40%
- Substantially increase federal non-defense research and development spending (National Economic Council, Council of Economic Advisors, and the Department of Energy)
- Develop policies to reduce the burden of health care expenditures on U.S. firms and workers (Departments of Labor, Commerce, and Health and Human Services)
- Expand enforcement of U.S. trade remedy laws and establish an independent agency to self-initiate such complaints (Office of the United States Trade Representative (USTR) and the Department of Commerce)

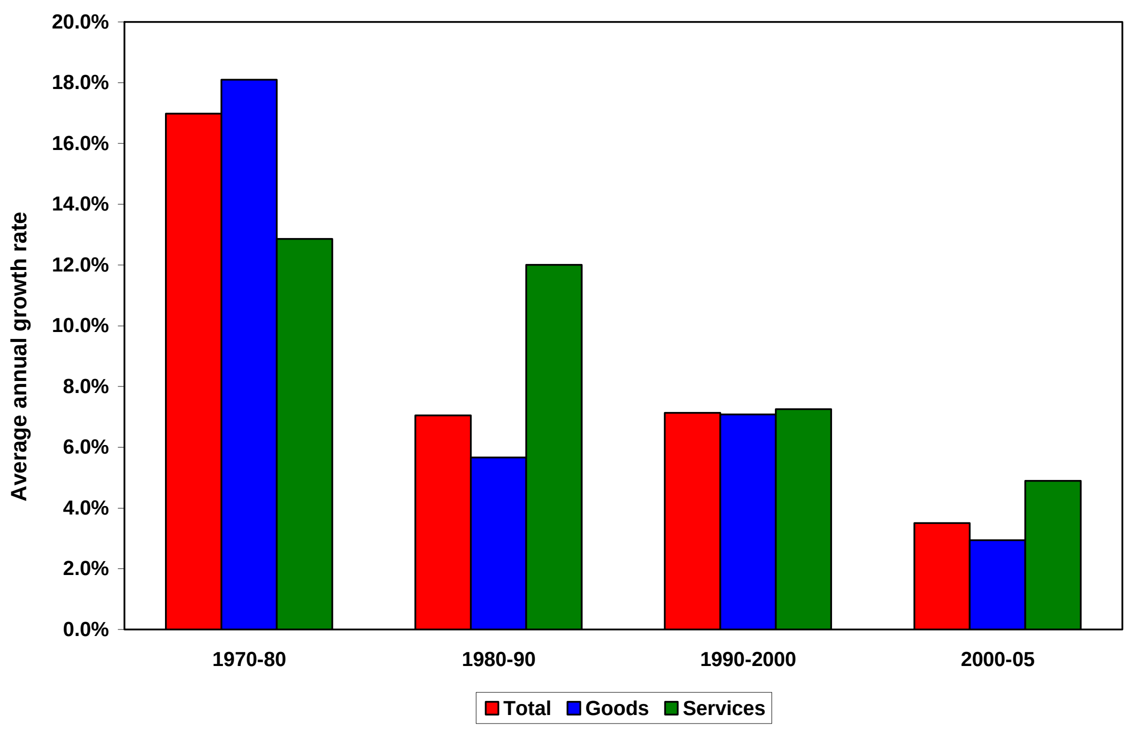
The U.S. National Export Strategy is fundamentally flawed

The 2005 National Export Strategy[2] (NES) is a three-pronged strategy: promoting new Free Trade Agreements, identifying promising market opportunities for U.S. business, and increasing exports to China. Each of these elements reflects a deep-seated confusion about the nature of U.S. trade patterns and the determinants of U.S. export competitiveness.

The Clinton Administration frequently reported that it had negotiated more than 200 free trade agreements, and asserted that these had benefited U.S. exports.[3] Likewise, the 2005 NES claims that the 12 FTAs that the administration has negotiated "will open markets for 124 million consumers to U.S. goods and services." Such assertions assume that mere approval of such agreements will result in improved export performance. Review of the historical record shows that nothing could be further from the truth.

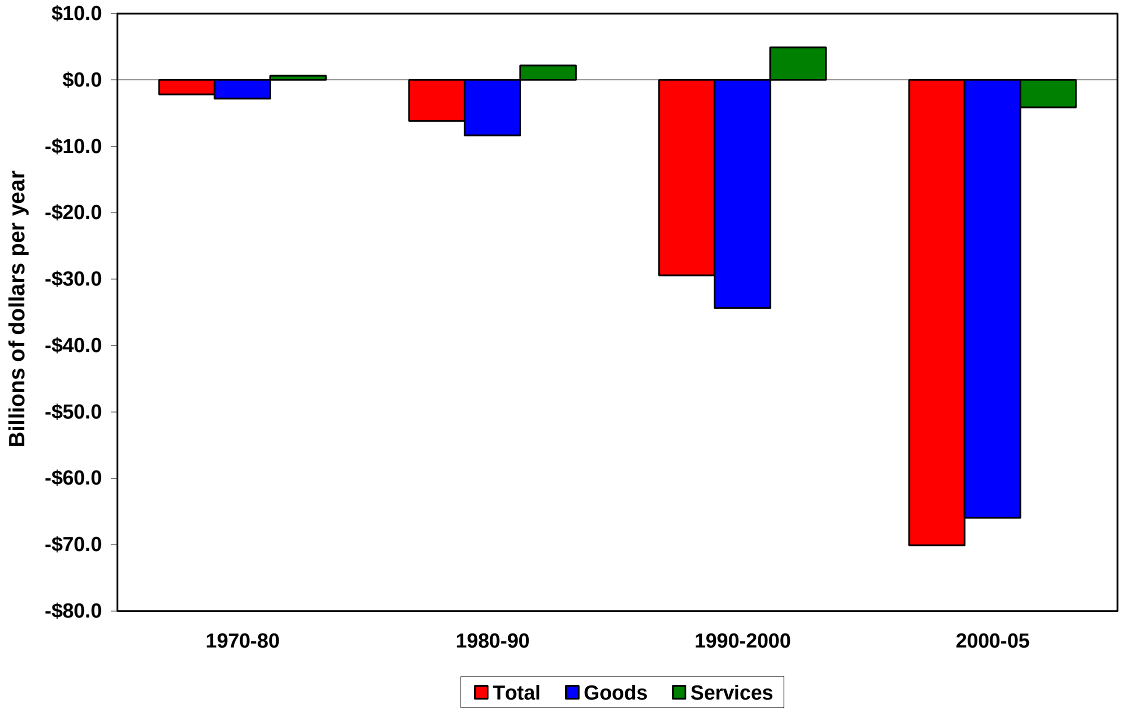
Figure A shows that the growth of U.S. exports has slowed in each succeeding decade since the 1970s. Clearly the 200 plus trade agreements negotiated by the Clinton and Bush Administrations have failed to translate into improved export growth performance. U.S. imports have grown faster than exports in every period shown in Figure 1. As a result, the growth of U.S. trade deficits has also accelerated over the past 25 years, as shown in **Figure B**. Our National Export Strategy has been a thinly disguised import strategy.

Figure A. Steadily declining U.S. export performance



Source: U.S. Department of Commerce, Bureau of Economic Analysis, and Economic Policy Institute.

Figure B. Growth of the U.S. trade deficit has accelerated, 1970-2005



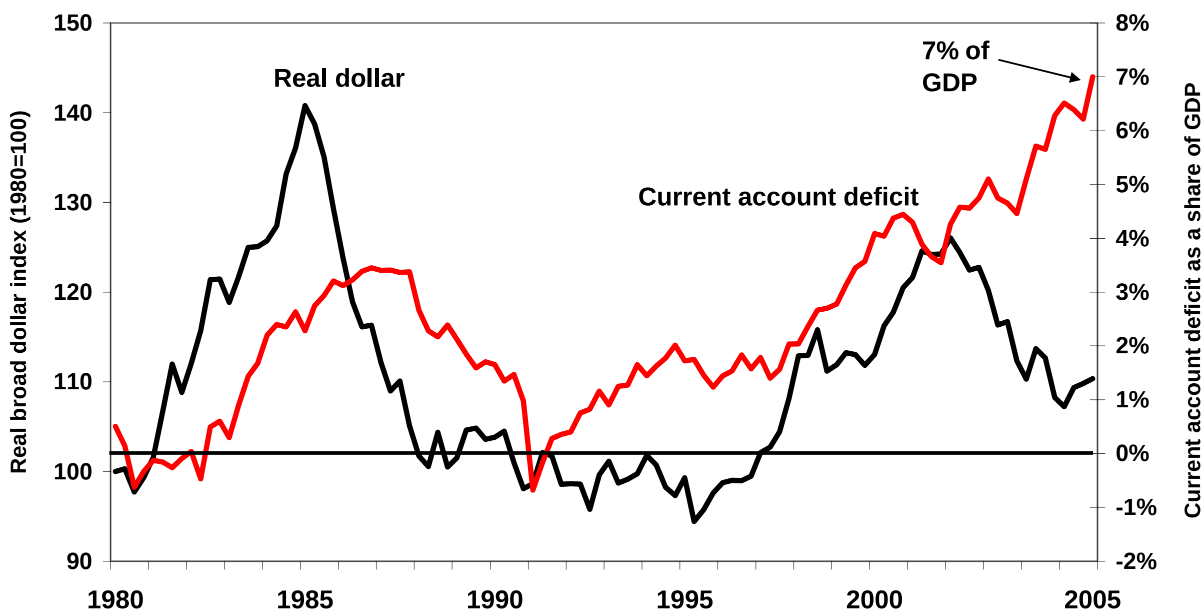
Source: U.S. Department of Commerce, Bureau of Economic Analysis, and Economic Policy Institute.

Programs to provide trade leads, promote U.S. participation in foreign trade shows, and make U.S. exporters more aware of foreign market opportunities can have, at best, a marginal impact on U.S. businesses. They presume that U.S. small businesses are simply unaware of foreign markets where they can effectively compete.[4] However, the United States suffers from a number of fundamental economic problems that undermine the competitiveness of small and large U.S. businesses and the attractiveness of this country as a location for production. Many large U.S. firms are "competitive" in foreign markets, and here at home, but only because they have chosen to offshore a growing share of goods production. The challenge facing the United States, as a country, is to identify new policies that make it economically efficient to produce more export (and import-competing) goods in this country. The fundamental competitive challenges confronting U.S. producers include: the highly overvalued dollar, persistent foreign barriers to U.S. exports, highly unbalanced trade with some countries such as China, rapidly growing health care expenditures and low levels of federal research and development (R&D) support.

In addition to flawed and poorly enforced trade agreements, rapid growth in the value of the U.S. dollar since 1995 has also greatly reduced the competitiveness of all U.S. firms. Overvaluation of the dollar increases the costs of U.S. exports and reduces import prices in this country. The trade deficit has increased from 2 % of GDP in 1995 ($110 billion) to 7 % in the fourth quarter of 2005 ($900 billion, at an annual rate).

In the mid-1980s, the last period when the United States. experienced a large and rapidly rising trade deficit, the Reagan Administration organized a coordinated international campaign to reduce the value of the dollar. Treasury Secretary James Baker met with the G-5 in 1985 and hammered out the plan, the Plaza Accord, to bring down the dollar and bring about an orderly adjustment of spending in other countries. The dollar fell about 25% over the next two years, and by 1990, the current account deficit declined to a more manageable 1% of GDP, as shown in **Figure C**.

Figure C. Overvaluation of the dollar since 1995 contributes to the trade deficit



Source: Federal Reserve Board of Governors, Bureau of Economic Analysis, and Economic Policy Institute.

A trade deficit means that, as a nation, the U.S. is consuming more than it is producing. Simple accounting rules show that it must borrow from abroad to finance this consumption, just as a consumer must borrow any time his or her income is less than total spending. In 2004 (the most recent year for which we have complete and accurate data), foreign central banks provided 75% of the funds required to finance the U.S. current account deficit.[5] Most of these purchases were made by Asian central banks, including roughly $200 billion by China alone (40% of total central bank purchases of U.S. assets in 2004). Such purchases constitute massive currency intervention, designed for the express purpose of maintaining an artificially undervalued currency. China's currency intervention, which is designed to maintain an exchange rate that has been fixed to the dollar at virtually the same price since 1994, is one important explanation for the explosive growth of the U.S. deficit with that country, which is the largest and most rapidly growing bilateral deficit in the world.

U.S. imports from China are six times as large as U.S. exports, making it this country's most imbalanced relationship. U.S. exports to China would have to grow six times as fast as imports to keep the trade deficit from growing. Thus, claims about rapidly growing exports to China in the NES (NES 2005, 9) are beside the point. Rapid growth from a very small base of exports has not slowed the growth of the U.S. deficit with China. Furthermore, although U.S. exports to China did increase 22% in 2004, imports *increased* 29%, on a base that was six times as large, and therefore the trade deficit *expanded* 31%. Imports from China also grew faster than exports in 2005.

Japan, China, and many other countries also maintain substantial tariff and non-tariff barriers to U.S. exports. For example, there have been extensive trade disputes with Japan and Korea about formal and informal barriers to U.S. auto parts exports. These barriers have been documented in the annual U.S. trade estimates reports.[6] Recent administrations have failed to achieve the removal of these barriers, despite the substantial leverage obtained from the large volume of imports from each of these countries.

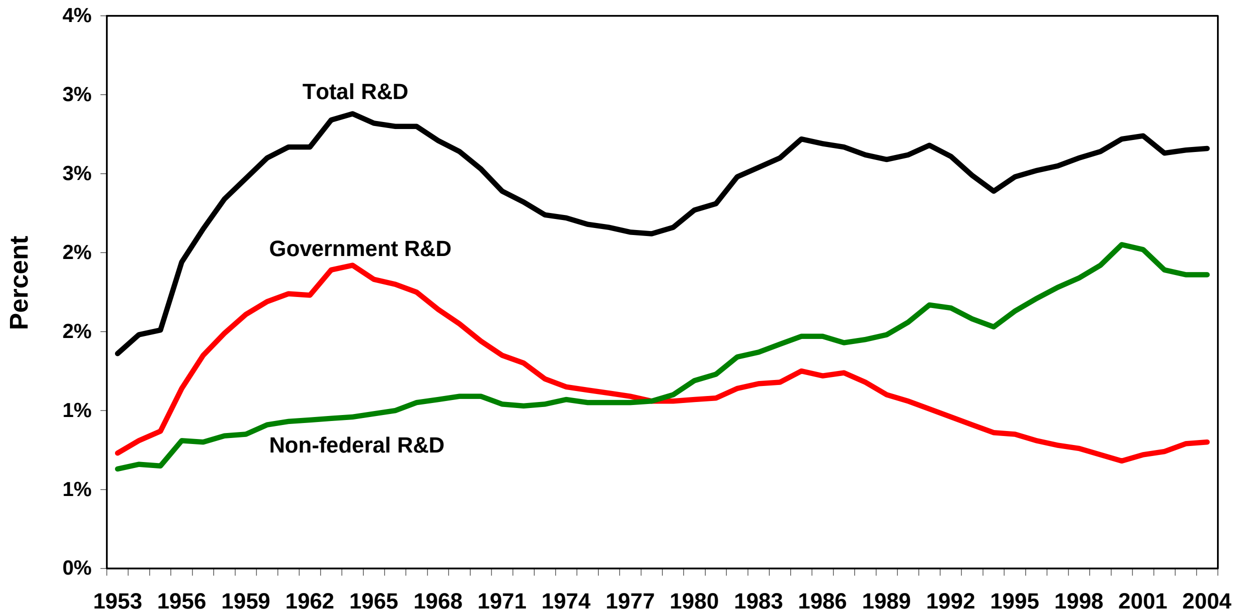
Another source of declining competitiveness for U.S. exporters is the rapid rate of growth in health care costs. Competitors in Europe, Japan, Canada, and a number of other countries do not directly bear the costs of health care expenditures, or their expenditures are much lower (as in Japan), because of a well developed national health care program. Health care expenditures as a share of GDP are also substantially higher in the United States than in other exporting countries.

Health care costs are rising much more rapidly than wages in the United States, especially in real terms. Between 1999 and 2005, nominal wage and salary growth averaged 3.5% per year, while benefits grew 4.1% per year.[7] Since, on average, U.S. firms have been cutting expenditures on pensions, the rate of growth of health care expenses is likely well in excess of 4 % per year. This is particularly true for manufacturing firms, where firms are more likely to provide health benefits than in many other parts of the economy.

The competitiveness of U.S. exports is also hurt by relatively poor levels of research and development spending in the U.S., especially at the federal level, and also relative to other countries.[8] Total U.S. R&D (public and private) has hovered around 2.6% of GDP since the mid-1980s. The most recent statistics suggest several causes for concern. First, total federal spending for R&D has fallen from a peak of 1.9% of GDP in the mid-1960s to 0.8% in 2004. A large share of federal spending in the 1960s was for defense and space purposes, which generate fewer commercial applications than other forms of publicly funded research. However, the share of civilian-related federal R&D spending fell from about 19% of total in the late 1970s to 11% in 2003.[9] Federal spending for civilian R&D is particularly important to the long-term competitiveness of U.S. manufacturing because it supports fundamental research that usually does not have immediate commercial applications but has the potential to open up vast new markets. The most famous example is the Internet, which evolved from the federally funded DARPA-net that was developed for communication among universities and government agencies in the 1980s.

The second cause for concern is that private spending on R&D, as a share of GDP declined noticeably after 2000, as shown in **Figure D** below, drawn from the 2004 National Science Foundation (NSF) report:

Figure D. R&D as a shares of gross domestic product: 1953-2004



National Science Foundation, Division of Science Resources Statistics, National Patterns of R&D Resources, http://www.nsf.gov/statistics/infbrief/nsf06306/, and EPI

The decline in non-federal R&D between 2000 and 2004 was 0.2 percentage points, or about $20 billion. The failure of this spending to recover even two years after the recession suggests that rapidly growing trade deficits may have reduced resources for and pay-offs from investments in manufacturing R&D. This may help explain why the trade deficit is still growing despite an 11% drop in the real value of the dollar (as shown in the Figure above).

Concerns about the decline in federal research spending are reinforced by recent announcements that U.S. firm are moving R&D operations offshore. For example, Delphi Corporation recently announced the opening of a research center in Shanghai.[10] The center has “two experimental buildings with more than 500 engineers, scientists and technical professionals.” As U.S. manufacturing firms move research activities offshore, there is growing concern that these moves will undermine the competitiveness of the United States as a location for production.

A final cause for concern is that current levels of U.S. R&D spending is now behind that in other leading countries, and substantially so in some cases. The NSF (2003) reported that the U.S. ranked number six in the world in the 2000-03 period in R&D spending as a share of GDP (at 2.7% of GDP). The United States ranked behind Israel (4.9%), Sweden (4.3%), and Japan (3.1%), among others.

But the concern does not end there because 19% of total U.S. R&D spending is for defense and space-related purposes (NSF 2003). This spending generates relatively few commercial benefits, and does little to increase U.S. export competitiveness. Most other countries do not sustain non-commercial R&D spending at these levels. Once space and defense programs are removed, total U.S. federal non-defense and commercial R&D falls to 2.17% of GDP. This level is below the Organisation for Economic Co-operation and Development (OECD) average of 2.26% and drops the United States into the 15th place overall in country-GDP shares of R&D, behind most European countries, as well as South Korea (2.64%).

Time for a new National Export Strategy

The TPPC and their NES report appear to assume that export promotion (e.g. through expansion of trade leads program) and greater inter-agency co-ordination can substantially increase the rate of growth of U.S. exports. This strategy fails to recognize the barriers confronting U.S. exports, which include a massively overvalued dollar, high foreign barriers to U.S. exports, high and rapidly rising health care costs, and low levels of federal R&D spending relative to other developed countries.

There is another significant barrier to improvement in the U.S. trade deficit, which is the massive imbalance that exists between U.S. exports and imports. In the second half of 2005, U.S. imports were 58% larger than U.S. exports.[11] Thus, U.S. exports will have to grow 58% faster than imports in the future, just to keep the trade deficit from expanding. This will require fundamental changes in policy. Tinkering around the edges will not address the massive U.S. export performance problems.

Briefly, U.S. policy responses should include:

- The U.S. Treasury should admit that China is preventing its currency from rising to the appropriate value (currency manipulation) in its semi-annual exchange rate report, and begin negotiations with China leading to termination of these practices
- Work with other members of the G-8 to develop a concrete plan for bringing about a sustained and substantial reduction in the value of the U.S. dollar of at least an additional 30% to 40%
- Substantially increase federal non-defense research and development spending (National Economic Council, Council of Economic Advisors, and the Department of Energy)
- Develop policies to reduce the burden of health care expenditures on U.S. firms and workers (Departments of Labor, Commerce, and Health and Human Services)
- Expand enforcement of U.S. trade remedy laws and establish an independent agency to self-initiate such complaints (Office of the U.S. Trade Representative and the Department of Commerce)

These measures directly respond to the export barriers reviewed in this statement.

Because these measures will also expand production and exports of U.S. manufactured goods, they will also be of great help to U.S. small businesses. Many small manufacturing businesses are suppliers to larger firms that are large enough to generate substantial exports. Thus, these smaller firms both directly (e.g., through new health care policies) and indirectly benefit from the entire range of export promotion measures listed above. For example, in 2002 there were 184 firms engaged in aircraft production, a major export sector.[12] However, only a few of these firms were major exporters (e.g., Boeing and Northrop Grumman). Most are suppliers of aircraft parts to the major integrators. Likewise, there were 297 firms making aircraft engines and engine parts, though again there are only a few major integrators, such as General Electric, in the industry.

Thus, the best way to stimulate small business exports is by building the foundations for a strong national export growth. When manufacturing output and exports begin to grow rapidly, the rising tide will lift all boats.

This concludes my prepared remarks. I would be happy to answer any questions you have. Thank you for your interest and attention.

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[1] This statement examines the economic context of export promotion programs and identifies alternative government policies that could improve the export performance of large and small businesses in the United States. The 2002 report of the U.S. General Accounting Office to the Small Business Committee showed that the TPPC has failed to "discuss agencies' specific goals or assess progress made" in implementation of the National Export Strategy. (United States General Accounting Office, *Export Promotion: Mixed Progress in Achieving a Governmentwide Strategy*, GAO-02-850, September 2002).

[2] Trade Promotion Coordinating Committee, *The 2005 National Export Strategy*, May 2005.

[3] See, for example, Scott, Robert, *Will CAFTA be a boon for farmers and the food industry*? Economic Policy Institute, June 2, 2005, http://www.epi.org/content.cfm/ib210 for an analysis of Clinton Administration promises about the promised benefits of the NAFTA agreement for U.S. farmers versus actual trade outcomes after the agreement took effect.

[4] This strategy is also premised on the assumption, based on Census reports, purporting to show that large shares of U.S. exports come from small businesses in the non-manufacturing sectors. However, 86% of U.S. merchandise exports are produced by the U.S. manufacturing sector, where large businesses play a more important role in directly exporting their products. Improvements in the fundamental determinants of U.S. competitiveness, such as the value of the dollar, will directly benefit small and large businesses, including small manufacturing businesses who supply the big exporters (as shown below) and small firms in the non-manufacturing export sectors.

[5] Scott, Robert. 2005. *Foreign Liabilities Are Increasing Rapidly, Especially to Foreign Central Banks*. Economic Policy Institute. Economic Snapshot. June 30. http://www.epi.org/content.cfm/webfeatures_snapshots_20050630.

[6] For a summary of one such report see, *House Democrats Call On Bush Administration To Act To Remove Unfair Trade Barriers, Not Just "Estimate" Them*, Press release from Representative Charles Rangel, April 1, 2004. http://www.house.gov/apps/list/press/wm31_democrats/040401bush_admin_remove_unfair_trade.html.

[7] Bureau of Labor Statistics, *National Compensation Survey*, http://www.bls.gov/ncs/home.htm.

[8] See National Science Foundation, *U.S. R&D Continues to Rebound in 2004,* January 2006, http://www.nsf.gov/statistics/infbrief/nsf06306/nsf06306.pdf.

[9] National Science Foundation, *National Patterns of Research and Development: Resources: 2003,* http://www.nsf.gov/statistics/nsf05308/.

[10] Xinhua News Service. *Auto-parts giant Delphi Corp. opens technical center in Shanghai*. April 19, 2006, www.chinaview.cn.

[11] Scott, Robert. 2006. *U.S. current account deficit breaks record at 7% of GDP*. Economic Policy Institute Current Account Picture: March 14. http://www.epi.org/content.cfm/webfeat_econindicators_capict_20060314.

[12] U.S. Bureau of the Census, *2002 Economic Census: Census of Manufacturers, Sector 31: Manufacturing: Industry Series: Historical Statistics for the Industry: 2002 and Earlier Years*. http://factfinder.census.gov/servlet/IBQTable?_bm=y&-ds_name=EC0231I1&-ib_type=NAICS2002&-NAICS2002=336411|336412&-geo_id=&-_industry=336412&-NAICS2002sector=8699171&-_lang=en&-fds_name=EC0200A1.