WHY ADD AN INTEREST RATE HIKE ON OUR STRUGGLING SMALL MANUFACTURERS

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WHY ADD AN INTEREST RATE HIKE ON OUR STRUGGLING SMALL MANUFACTURERS?

WEDNESDAY, APRIL 24, 2002

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to call, at 10:05 a.m. in Room 2360, Rayburn House Office Building, Hon. Donald Manzullo presiding.

Chairman MANZULLO. The Committee will come to order. We will get started, Dr. Ferguson. If you could please have a seat.

Good morning and welcome to this hearing of the Committee on Small Business. I especially want to welcome those who have come some distance to participate.

A little over a month ago I sent a letter to Federal Reserve Board Chairman Alan Greenspan encouraging him to resist interest rate hikes in the near future. I explained that an important sector of our economy, namely small manufacturers, were still in recession. I further encouraged him to look at the state of the machine tool industry as a key indicator of America's economic health.

It now appears, and I am pleased to observe that the Federal Reserve will not raise interest rates at its next meeting on May 7th. I do not know if it is in direct relation to the letter we sent, but we certainly were beating the drums that we have got a long way to go to recover.

Let me just raise a couple of things, raise eight factors that I believe are extremely important. Before the Washington Post had called Rockford, Illinois, which is my home city in the center of our congressional district, a "Barometer In The Heartland." That was the headline of a 3-page story in the Post's March 25, 2001 edition. The sub headline says "Rockford Holds Clues to Shifts in the U.S. Economic Climate." The article notes the influence that Rockford's situation should have with the Federal Reserve policy makers. Rockford was a national predictor in the early 1980s when its unemployment led the nation at 25.9 percent. More people were unemployed proportionally in Rockford in 1980 than they were in the Great Depression.

There are eight factors that are contributing to tough times for small manufacturers, and those will be touched on across the board today: stiff foreign competition that is allowing for very thin margins, number one; number two, new steel tariffs that are increasing the costs of American production; three, an overvalued U.S. dollar making American manufacturers less competitive; four, tighter credit standards preventing small manufacturers from securing needed loans; five, U.S. export controls and unilateral sanctions that limit the ability of American companies to compete internationally; six, increased productivity leaving many businesses overstaffed and facing job cuts; seven, the heavy U.S. tax burden and how it places American companies at competitive disadvantages; and finally, eight, government regulations continuing to overburden struggling American businesses.

We called this hearing several weeks ago because we don't want to add a ninth factor to that. And that would be increased costs of doing business through an increase in the interest rate. So we are going to have a great hearing today. I look forward to the testimony of all the witnesses. And I now yield for an opening statement from our good friend and colleague, the Ranking Member Ms. Velázquez of New York.

Ms. VELÁZQUEZ. Thank you. Thank you, Mr. Chairman.

When Americans think of small businesses the first image that leaps to mind is the small manufacturer. The entrepreneur takes raw materials and produces real, innovative products. Small manufacturers still form the bedrock of our economy, and they deserve our support.

Today we are examining the effects that a potential interest rate hike by the Federal Reserve would have on more than 35,000 small manufacturers in this country. I think everyone here agrees that now is not the time for a Fed rate hike. The economy is not growing fast enough to worry about inflation. I am pleased to learn that Chairman Greenspan shares this assessment.

Given that reality I believe that in addition to examining the impact of a federal hike, it is important to assess the long term and substantial barriers that small manufacturers face. By focusing on these challenges today and implementing a strategy toward overcoming these challenges, I am sure we can do far more to help small manufacturers than the Fed can do to harm them. Small manufacturers, even in an economic downturn, are having a difficult time hiring skilled workers to get the job done.

A long time has passed since Henry Ford reduced manufacturing to an assembly line process that could employ practically anyone regardless of skill or education. Today manufacturers require a highly trained technical workforce. Because the skill barrier is so high, often these manufacturers are reduced to paying for worker training themselves only to have them leave for bigger companies and better benefits. We want to make it easier for small companies to pay for worker training and to hold on to those employees they train.

In addition, we know that technical assistance can double the success rate of small manufacturers. Programs such as the Manufacturing Extension Partnership can bring small manufacturers together with mentors and experts to increase productivity and profitability. Unfortunately, the Manufacturing Extension Partnership is another in a long list of vital small business technical assistance initiatives facing cuts under the President's budget proposal.

Another major concern to small manufacturers is access to capital. Small manufacturers are not just worried about the costs of capital, they are also worried about the supply. When small manufacturers cannot get capital, they cannot buy new equipment. Without new equipment their productivity falls and so does their competitiveness. One obstacle blocking the path to increased capital supply is the 7(a) Loan Program. The recent budget proposal would cut this program in half, keeping an additional $5 billion in capital out of the economy, capital that could be financing new equipment and productivity. Instead it sits in a ledger somewhere at the Treasury, in effect a subsidy of the federal government by this country's small businesses.

I look forward to the opportunity today to examine the Fed's impact in addition to highlighting other issues and challenges facing them. We are beginning the process of examining the challenges facing small manufacturers, which are the lifeblood of many communities across the country. I hope we can learn more about what we can do to help them thrive.

Thank you, Mr. Chairman.

Chairman MANZULLO. Thank you.

Our first witness, it is a real honor to have Dr. Ferguson with us again today. Dr. Ferguson, I want to commend you for the outstanding leadership that you lent to this country after the horrible events on September 11th, in helping to spear up the literally small group of people involved in the government to pump liquidity in the markets to stop a panic. And I just do not think that Americans realize the tremendous job and the wisdom and the insight of what that literally handful of people did in that time of crisis.

Dr. Ferguson holds two doctorates, and he is the Vice Chairman of the Board of Governors of the Federal Reserve System. And it is a real honor and pleasure to have you here today.

Matthew, turn off the clock, we do not need that for Dr. Ferguson.

I look forward to your testimony, and your entire statement will be made part of the record. Thank you, sir.

STATEMENT OF HONORABLE ROGER W. FERGUSON, VICE CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE BOARD, WASHINGTON, D.C.

Mr. FERGUSON. Thank you very much, Mr. Chairman.

And let me also say it is a pleasure to appear before your Committee this morning to update you on recent economic developments and on the availability of credit to small business. In doing so, I want to emphasize that I speak for myself and not necessarily for the Federal Reserve.

When I met with your Committee almost one year ago, overall economic activity had slowed noticeably after several years of rapid expansion. What looked at the outset to be a gradual cooling of an overheated economy became much more serious, particularly in the manufacturing sector, for several reasons. First, the shakeout in the high-tech sector proved to be not simply an adjustment to slower domestic demand but a more fundamental reassessment by businesses, globally, of the profitability of additional fixed capital added to the already high stock of such capital. Besides the plunge in demand for high-tech products, our exports were hit hard by the slowdown in economic growth abroad. Lastly, the shock to confidence and spending in the wake of the tragic events of September

11 extended the weakness in the economy that had emerged over the first half of the year.

As the economic slowdown unfolded during 2001, the Federal Open Market Committee moved aggressively to counter the weakening in economic activity and to limit the extent of the downturn. In the event, I believe that monetary policy substantially cushioned the negative forces weighing on the economy. Homebuilding was visibly buoyed by lower mortgage rates. At the same time, auto makers drew a record number of new car buyers into showrooms by offering generous financing deals. Indeed, in contrast to earlier economic contractions, consumer spending held up remarkably well last year. The favorable effects of lower interest rates on borrowing costs and the boost to disposable income from the federal tax cuts and falling energy prices largely offset the deterioration in consumer confidence, the decline in wealth from lower equity values, and the rise in unemployment.

Compared with the previous four downturns that we had experienced since 1969, last year's downturn appears to have been mild overall. However, it differed importantly in its composition. Between the first and fourth quarters of last year, real disposable income, real personal consumption expenditures, and real outlays for residential construction increased more rapidly than in the preceding four economic downturns. In contrast, because of the particularly sharp retrenchment in capital spending for high-tech equipment, firms cut back their capital spending more extensively than was typical of earlier business cycles. The inventory correction was much more prompt, and as the cycle played out, it became a more substantial drag on domestic production than had been the case in earlier downturns.

Because the cutbacks in demand centered on goods, the manufacturing sector was hit particularly hard. Indeed, the contraction in manufacturing production began in the second half of 2000, well before the cyclical peak in March of 2001, when the inventory correction and retrenchment in capital spending developed. And, though the recession in real GDP was mild by historical standards, the cumulative drop of more than 7.5 percent in manufacturing industrial production from June 2000 through December 2001 was larger than the decline in any of the previous four recessions. As a result, capacity utilization in manufacturing dropped over that period to 73.1 percent in the fourth quarter of last year, 7¾ percentage points below its longer-run average.

On a more positive note, two other distinctive aspects of last year's recession are important for the longer-run outlook. The economy entered the recent slowdown, first, with a much lower rate of inflation and, second, with a noticeably higher rate of increase in productivity than during the other recession episodes since the mid-1970s. In both cases, the favorable performance has been well maintained into the first part of this year and provides a solid basis for a return to sustained no inflationary economic expansion.

As Chairman Greenspan reported in his testimony before the Joint Economic Committee last week, prospects for a renewed expansion have now brightened significantly. The economy appears to have been expanding at a significant pace in recent months. Household spending is holding up well, business spending on new equipment appears to have firmed, and preliminary data suggest that inventories are being drawn down less rapidly than at the end of last year. Of course, I should caution that at this early stage the degree of strengthening of final demand, which is a key factor in shaping the contour of the upturn, is still uncertain.

That said, our estimates of industrial production, which were released last week, indicate that manufacturers have begun to benefit form the pickup in the economy to date. Overall industrial production began to increase again in January, and the indexes for almost 60 percent of the individual series for which we calculate production were by February above their levels three months earlier. We estimated another broad-based gain of ¾ percent in IP in March.

Of course, the cyclical recovery in the manufacturing sector will be superimposed on the longer-run structural trends in domestic goods production. Our manufacturers have over time been a strong and steady source of advances in productivity, and thus, the sector continues to be a significant contributor to the nation's overall economic growth. At the same time, because advances in manufacturing have required increasingly less of our economic resources, they have implied a noticeable secular decline in the share of jobs in the manufacturing sector.

Furthermore, the increased globalization of goods production and the competitive pressures that have ensued have had additional consequences for the extent to which worldwide demand for goods has been met by U.S. firms and their workers, and those consequences have varied by industry.

Turning to issues more directly related to small businesses, I want to begin by noting that the results of the Federal Reserve Board's Survey of Small Business Finance had just become available when I testified before your committee last May. At that time, I discussed with you in broad terms our findings regarding the use of credit and other financial characteristics of small businesses.

As we have discussed before, the Survey of Small Business Finances can be used to examine a range of issues, including the study of specific groups of firms. This morning I would like to draw on the results of the survey to focus on what they tell us about small manufacturing firms.

According to our 1998 survey, about 8 percent of the more than 5 million nonfarm, nonfinancial small businesses, that is those with fewer than 500 employees, were manufacturing firms. Those manufacturing firms were larger than other small businesses: Both average employment and average receipts at small manufacturing enterprises were about twice those at other small businesses. As a result, small manufacturing firms accounted for about 14 percent of small business employment and around 17 percent of small business receipts.

Despite considerable structural change and consolidation in the financial service sector and the increased accessibility to capital markets by small businesses, commercial banks continued to be the dominant provider of financial services to most non-tech small businesses in 1998. These patterns were similar for manufacturing and nonmanufacturing firms.

No doubt, the economic and financial environment has become less conductive to risk-taking and leverage since the survey was conducted in 1998. The economic slowdown of the past year led to a deterioration of corporate profits and an acceleration of bond defaults and loan delinquencies. As profits fell and businesses revised down their expectations for sales and their expansion plans, investors became less certain about the returns they should expect on investments. The dramatic rise in problem credits and the rapid pace at which we saw firms fall from stellar ratings to bankruptcy also led investors to reevaluate their views about the financial well-being of businesses and their creditors.

Thus far, we have seen few signs of the types of financial headwinds that in the early 1990s had played havoc with the ability of many creditworthy small firms to roll over loans and renew credit lines. Credit flows to businesses have fallen much more modestly in the recent cycle, even as firms slashed their investment in fixed capital and inventories. Moreover, financial institutions have maintained their capital and liquidity as delinquency rates of business and real estate loans did not reach the highs witnessed in the earlier period.

As the Federal Reserve aggressively cut the federal funds rate in 2001, borrowing rates for most businesses dropped sharply despite persistently high risk spreads for lower-rated firms. Low interest rates prompted investment-grade nonfinancial corporations to issue a record volume of bonds, and issuance continues to be strong this year. These firms used the proceeds to strengthen their balance sheets by repaying short-term debt, refinancing other long-term debt, and building up liquid assets.

Though investors appeared cautious, non-investment-grade companies were also able to raise funds: junk bond offerings have accounted for about one-quarter of total public debt issuance. At commercial banks, rates on business loans declined, but loans at large banks fell sharply. In contrast, loans at small banks, which make many loans to small businesses, expanded moderately last year and have continued to do so this year.

As you are aware, the Federal Reserve regularly surveys senior lending officers around the country, principally at large banks, but also at a selection of small banks. The survey, which is administered quarterly, asks banks about their credit terms and standards, loan demand, and other issues that may be topical. During the market turmoil in late 1998 banks began looking harder at the loans they made to large and middle-market businesses. In each quarter over the past three years, more banks reported having firmed their lending standards than reported having eased their lending standards for large and medium-sized borrowers. Not surprisingly, banks have been particularly vigilant during the recent economic downturn with 40 to 60 percent, on net, having tightened their lending standards. Of particular relevance to this committee is the fact that the net portion of banks that reported having tightened their lending standards for small borrowers was about 10 percentage points below the net portion that reported having tightened standards for larger borrowers.

The senior loan officer survey also questions banks about why they tightened their lending standards. In 2001 banks commonly cited uncertainty about the economic environment, worsening industry-specific problems, and a reduced tolerance for risk. The survey further questions banks about their perception of borrower demand. In the most recent survey, about one-half of the banks surveyed reported that the demand for business credit continued to decline, a high fraction by historical standards, but lower than the roughly three-fourths that reported declining demand in the fourth quarter of last year.

Banks attributed declines in loan demand to reductions in planned investments and diminished financing for mergers. This view held by bankers is confirmed by surveys of small businesses. According to surveys conducted by the National Federation of Independent Business in 2001, only about 12 percent of respondents on average thought that it was a good time to expand, roughly half the percentage of a year earlier. Few firms reported financing costs as a reason for believing that expansions were not a good idea.

Indeed, since the beginning of 2001, NFIB respondents have not viewed financial conditions as onerous. The percentage reporting that they found credit more difficult to obtain has remained moderate and well below the highs witnessed in previous economic downturns. In addition, for creditworthy small businesses, interest rates on bank loans have declined with the easing in monetary policy. The average short-term interest rate paid by NFIB respondents decreased about 3 percentage points to its lowest level in more than two decades.

Though we may take comfort from the lack of angst expressed by small borrowers in the NFIB surveys as well as from the lower loan interest rates, we must recognize that given the tighter lending standards some small businesses have almost certainly found credit difficult and more expensive to obtain. Small manufacturing firms, in particular, may have faced tight credit constraints, as their profitability fell sharply last year and their business prospects became more clouded.

Indeed, such constraints are suggested by a recent survey conducted by the National Association of Manufacturers, an association whose membership is heavily weighted toward small and middle-market manufacturing firms. The survey found that 2 percent of respondents though it was "impossible" to get credit, a further 16 percent reported that it was "much more difficult" to do so, and another 16 percent reported that it was "slightly more difficult" to do so. Of those experiencing difficulty in obtaining credit, 19 percent cited tougher credit standards as the explanation. But nearly 40 percent of the respondents cited a decline in profits and a slowing economy as the explanation for experiencing difficulty in obtaining credit.

However, I note that recent data from the Quarterly Financial Reports of Manufacturing, Mining, and Trade Firms show that outstanding bank loans to manufacturers with less than $25 million in total assets actually increased moderately in 2001. In contrast, bank loans to larger manufacturing firms were falling.

Let me conclude and summarize by saying that obviously 2001 was a rough year for the economy. And given the nature of the downturn it was particularly rough for the manufacturing sector. Credit flows did slow, driven largely by the falloff in the demand for funds as the economy softened and the reduced pace of merger and acquisition activity. Overall, the tightening in credit standards that occurred was principally a response to the weak economy and declining profits, and thus it reflected a prudent pulling back of lending.

The outlook, however, has brightened: Industrial output has begun to turn up, and various surveys of business conditions suggest that orders are increasing. These developments are encouraging signs, but they are no guarantee that a sustained solid expansion of final demand has gained traction, and we will be monitoring economic developments closely in coming months.

Accordingly, the assessment of the Federal Open Market Committee at its most recent meeting was that the risks to the outlook in the near term were balanced between economic weakness and pressures on inflation. The committee kept the federal funds rate at its current level of 1¾ percent which implies that monetary policy remains accommodative. The FOMC's focus will remain on fostering a balanced, noninflationary economic recovery. As you know, monetary policy works with one instrument in a national money market. As a result, we cannot and should not set policy with an eye to the outcome in a particular sector of the economy. However, we believe that promoting our longer-run objectives of maximum sustainable economic growth and financial stability will produce an environment in which the broadest range of businesses and households will prosper.

Mr. Chairman, that concludes my opening remarks. And I am pleased that you already noted that the entire statement will be read into the record. So at this stage I am ready to answer any questions.

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

Chairman MANZULLO. Thank you very much, Doctor. And thank you for that excellent testimony that was stated in terms that non-economists such as myself could understand. I always appreciate people that can take complicated issues and make it easier to understand.

One of the issues here that I like to raise, and we talked about it just before the Committee hearing today, and we sent you testimony of the other witnesses, goes to the indicators that the Federal Reserve is using. I do not know if you saw a letter that we sent to Chairman Greenspan on March 20. You may have but there——

Mr. FERGUSON. Yes.

Chairman MANZULLO. Are you familiar with the letter, Doctor?

Mr. FERGUSON. I am generally familiar with it. I am not sure that I have all of it.

Chairman MANZULLO. We have an extra here.

Matthew, why don't you take that to him.

Mr. FERGUSON. Okay, I have it here. Thank you.

Chairman MANZULLO. You have it there?

Mr. FERGUSON. Yes.

Chairman MANZULLO. Okay. Okay, thank you.

Doctor, on the last paragraph on the second page, we talked about various dynamics going on. And then it concludes based upon the fact that Rockford, Illinois, is the machine tool center of the world. Rockford was settled by the Swedes about 130 years ago.

They brought with them to Rockford the old world craftsmanship of carving tools for making furniture, furniture legs, and the lathing machines and things of that nature.

And then when steel took over from wood they took the talents involved in making the tools to cut wood to tools to cut steel, metal, different parts like that. And that is why Rockford became known as the tool center, tool and die center of the world. At one point it was known as the leading city in the country for furniture manufacturing.

So we have that old world tradition of craftsmanship that finds its way into cutting tools. And Rockford has a base of about 32, 33 percent manufacturing which is double that of every other city. And in that last paragraph, we encouraged Chairman Greenspan and the Fed to use the monthly U.S. Machine Tool Consumption Report that is released by the Association for Manufacturing Technology and the American Machine Tool Distributors Association as a key indicator of the overall health of the economy.

Could you comment on that, Doctor?

Mr. FERGUSON. Let me again say I will speak for myself. My perspective on the way one should think about getting indicators of the U.S. economy is to be very expansive and to seek data, both quantitative data, data that come from professional economists and models, etc., but also to think about and seek data from a wide variety of businesses to understand how the economy is functioning.

We have an economy that is $10 to $11 trillion. By definition it is unlikely that any single indicator will give you a complete picture of how such a large and complex economy is functioning. And so I do think it is important for us to reach out and choose a wide variety of data.

Indeed, we do that already to some extent. We have, as you know, 12 Reserve Banks who have boards of directors and who have active outreach efforts. And they, through the information they provide to the Beige Book and through the information that their presence provides when they come to FOMC meetings, give a great deal of input for how it feels around different parts of the country in this area.

Certainly we are also always interested in getting anecdotal information of one form or another. And, indeed, I personally have often encouraged the staff to look to various sectors that might have some sort of capability to be a leading indicator.

Chairman MANZULLO. Predictor.

Mr. FERGUSON. Predictor, as you have described it. And there are a number that we should be examining closely. And this one, since you have sent the letter to us, will obviously be one of the things that we will look into and make an effort to examine. And I think that, sir, is forthcoming and an appropriate kind of response.

If this indicator turns out to have what accountants describe as information value, then we need to understand that more fully. Our staff has been aware of this indicator over many years, and I suspect that we will now take a renewed interest in understanding the value that it could provide in understanding how the economy is likely to evolve over time.

Chairman MANZULLO. We appreciate that. In defense of the indicator, what is unique about the machine tool industry, Dr. Ferguson, is the fact that if there is a decrease in orders for the tools that go onto the machines that make the new or improved products, it is my belief that that is the first, actually that is the second sign. The first one I look to, is I call our steel producers back home and the steel sellers and say what is going on in machine tool sales. It is a high specialty steel. We worked and were successful in getting that exempt from the new tariffs. And the first indicator of a box that there is slowdown in the sale of steel that is used for making the machine tools, then that is how this Congressman judges the economy.

And that is exactly what happened in the spring of 2000 when the Fed raised the interest rate for the last time. I believe was it May or June?

Mr. FERGUSON. Yes.

Chairman MANZULLO. Was it June, Doctor?

Mr. FERGUSON. It was June. It was mid-year.

Chairman MANZULLO. It was in June. And we had sent a letter to Dr. Greenspan a couple months before then, saying please be very careful what you are doing because this indicator is showing up on our radar screen based on just a couple of phone calls that I made from my office.

So I am just thrilled that the Fed is going to take a look at that index. I look forward to working with you on a formal or informal basis. I would invite you to come to our Congressional District, meet with the small manufacturers, get a feel for what they are doing, some hands-on. Get some machine oil on your hands if that has not happened in your career. And then the heartbeat of America happens with this very select group of people that I believe is the best indicator of what is happening in manufacturing.

Mr. FERGUSON. Well, personally I do enjoy spending a great deal of time—I go out and give speeches and have done other things. And I was not in fact in Rockford, but I know where it is. I have been to other parts of Illinois, spent a fair amount of time, two days actually with a farmer in Logan County, Illinois, which as you know is incredibly rich in deep topsoil. And I found that very impressive. And I am sure an opportunity to visit in Rockford and understand more about machine tools and, what that life is like would also be beneficial and educational.

Chairman MANZULLO. Well, take this as a formal invitation. We will reduce that to writing.

Mr. FERGUSON. Fine.

Chairman MANZULLO. Thank you, Doctor.

Ms. Velázquez.

Ms. VELÁZQUEZ. Thank you, Mr. Chairman. And thank you, Dr. Ferguson, for your insightful presentation.

When we talk to small businesses in our nation and we ask them what is the top priority for them, they talk about access to capital. And in the current economic climate, Mr. Ferguson, small businesses are having difficulty in obtaining financing. And you touch on that in your presentation.

I would like to ask you, which do you think will have a greater impact on small manufacturers' access to capital, a 25 basis point increase in the federal funds rate, or cutting by 50 percent the capacity of the SBA 7(a) Program, loan program, as is proposed by the Administration's fiscal year 2003 budget?

Mr. FERGUSON. Well, you have managed to put into a question areas that I cannot predict and areas in which I am not an expert. And so, with all due respect, I know these are important issues, but I am not an expert on the SBA program. I know the importance of it. In fact, in the reports that we present every five years on small business we do occasionally have a paragraph about SBA. But I am really not in a position to give you the tradeoff of the two things that you just talked about.

Ms. VELÁZQUEZ. But, Mr. Ferguson, you do not need to be an expert on the loan programs of SBA. What I am asking you is, what do you think would be more harmful to small businesses, an interest rate increase or taking away $5 billion that would allow small businesses to access capital?

Mr. FERGUSON. Well, you are trying to draw me into a discussion about fiscal policy because the decisions of where taxpayers' money are being spent are ultimately fiscal policy. And as you well know, the Federal Reserve does not and I personally never comment on fiscal policy.

I will say by definition——

Ms. VELÁZQUEZ. I understand. It's okay.

Mr. FERGUSON [continuing]. That fiscal policy requires——

Ms. VELÁZQUEZ. I am not trying to put you in a difficult position here.

Mr. FERGUSON. Okay.

Ms. VELÁZQUEZ. I am just, asking you for a common sense answer to my question.

Small manufacturers are much more dependent on long-term interest rates because of their need for longer term loans to purchase equipment and other fixed assets. Yet Chairman Greenspan and former Treasury Secretary Robert Rubin have emphasized that long-term interest rates have failed to follow short-term rates because of market nervousness over the government's long-term fiscal position.

So I ask you now that the administration has spent all of the surplus and will soon be back in deficit spending; How will long-term interest rates be affected?

Mr. FERGUSON. One of the issues and challenges in economics is indeed to understand the forces that drive long-term interest rates. And the econometric evidence—the research—suggests that long-term interest rates reflect a wide variety of factors. In some cases it is supply and demand for the bonds that are sold that have a long maturity, and so you get special supply and demand influences. In some cases it is expectations about future policies of one sort or another. In some cases one sees what economists call an inflation concern, inflation threat. There are a number of things that go into determining long-term interest rates. And it is very hard, I have discovered, professionally to sort of parse out how those things all come together at any one point to determine what long-term interest rates will be.

Ms. VELÁZQUEZ. But among those factors we can consider too deficit spending?

Mr. FERGUSON. Well, I think perspectives about the future of policy broadly, both monetary and fiscal policy, play into issues of long-term interest rates, certainly.

Ms. VELÁZQUEZ. Dr. Ferguson, as the economy slowly recovers from the recession, how long do you anticipate it will take for banks to ease their lending standard towards small businesses? Are there policies that the Fed can pursue to improve the situation?

Mr. FERGUSON. Well, I think the role that we can play as supervisor of banks is to encourage banks to continue to focus on the creditworthy and creditworthiness of their counterparties. And I think as I have said in my statement, one of the reasons that I believe banks have tightened to some degree their terms and conditions has to do with perceptions about creditworthiness and also has to do with perceptions about the strength of the economy.

And I would presume that as the economy turns, banks will exercise reasonable and prudent judgment, which I think they have been doing, and reflect appropriately those changes. And beyond that, I think there is nothing more that we can encourage them to do other than to exercise reasonable and prudent judgment and to reflect, analyze, and understand creditworthiness and the economic outlook as best they can and take all of that into consideration in determining terms and conditions for loans.

Ms. VELÁZQUEZ. Thank you.

Chairman MANZULLO. Congressman Davis.

Mr. DAVIS. Thank you very much, Mr. Chairman.

Dr. Ferguson, let me just indicate that I appreciate your testimony and the insightful information that you have provided us with in terms of direction.

I want to ask, given increases in technology; Do you see a relationship between those increases and the ability of small manufacturers to survive and thrive and do well in this economy?

Mr. FERGUSON. Let me first talk about the role of small business in the U.S. economy by way of giving your answer.

As you know, small businesses account for about half the private nonfarm gross product in the U.S. Small businesses employ about half the private sector workers. Small businesses provide about three-quarters of net new jobs each year, or did between 1990 and 1995 based on some Commerce Department information. The reason I say that is that even as our economy has changed and evolved, small businesses have been and continue to be an important part of the economy.

To answer your question more directly, I believe even in a world in which technology and increased productivity are an important part of the positive benefits that we have experienced, small businesses can and indeed will compete successfully. For two reasons I believe that to be the case: first, we have seen that the costs of technologies, basic computers for example, hook-ups to the Internet, building a website with the appropriate kind of security, etc., all of that has actually quite rapidly been coming down, making those kind of investments available to small and medium size enterprises as well as to large enterprises. And I see no reason why a well-managed small business cannot participate in some of these productivity enhancements as much as a large institution can.

The challenge, obviously, is that one of the impacts of this investment in technology is it requires restructuring, for example, in order to get the full benefits. And by definition for many small businesses, opportunities to restructure may not be as big as for some large businesses. And so they can make the investments in technology. Their ability to get the full benefit may vary depending on the management skill of the individuals involved.

So I think I would continue to be optimistic that small businesses, which have been an important part of the U.S. economy, can continue to be an important part of the U.S. economy even as the economy itself changes, evolves, and becomes more heavily dependent on these new areas of technology because the costs of buying that technology, putting it into place in the small and medium size enterprise is becoming more and more manageable over time. It is not something that only the big can afford to do.

Mr. DAVIS. During the past, oh, three, four, five decades we have seen a tremendous decline in manufacturing in large urban areas. Do you see that have an impact on the overall economy? And do you see any way for us to reclaim some of that activity in big urban centers?

Mr. FERGUSON. One of the big things that I think has been driving decisions about the location of business has to do with the education of the workforce, and the second is I think the infrastructure, particularly the kinds of infrastructure that are required to make an area compatible with the high-tech kinds of investments that we were just discussing.

And certainly from a longer-term perspective, cities offer the potential to be very attractive. Cities have emerged out of economic history because of a natural desire for people to come together in certain locations and trade and do commerce with each other, and it is quite efficient to do that in a smaller area as opposed to a larger area. So the entire field of urban economics has theories of cities arising because they become natural gathering points or recognize natural gathering points of individuals who want to engage in commerce.

I think the challenge now has very much to do with creating an environment of a solid, well-educated workforce that is in cities, and adding to that the kinds of infrastructure investments that will make cities again attractive places to site particularly the more high-tech kinds of businesses that are an important part of what has made the U.S. economy so strong.

And so I would argue that one can be, while recognizing the difficulties that a number of cities have faced over the last generation or two, and I grew up here in Washington, DC, and I have seen things change here, there is some reason to be cautiously hopeful that a well-managed city that focuses on education and that focuses on infrastructure can succeed in bringing businesses back to the city.

And, indeed, one can look at Washington, DC. I do not have off the top of my head the statistics about businesses in Washington, but I do know, having lived here, having grown up here, and now again living here, that the city appears to be enjoying a certain amount of resurgence indicating that, indeed, a well-managed city can bring businesses back into the city and can indeed bring households back into the city and have the population start to rise again and bring in individuals who have the kind of entrepreneurial spirit that can take advantage of a well-educated workforce and also the kinds of technology investments.

So there is some possibility that the declines that we have seen in cities could possibly be reversed with the kinds of investments in what is called human capital and also actual physical capital.

Mr. DAVIS. Thank you very much.

Mr. FERGUSON. Thank you.

Mr. DAVIS. Mr. Chairman, education is as much of a factor as much of the other factors.

Mr. FERGUSON. That is certainly my personal belief.

Chairman MANZULLO. Thank you.

Congressman Bartlett.

Mr. BARTLETT. Thank you very much. I am sorry I could not be here for your testimony. We had a mark-up in the Morale, Welfare and Recreation Panel, important to our military people.

When interest rates go up, and I was in another life a small business person, when interest rates go up obviously that increases the cost of doing business. If interest rates were to go down, all of the things remaining equal, your profits would go up. So if interest rates go up, profits then go down.

Now, if you are a startup company and have no profits and there is an increase in interest rates that may simply mean that you no longer qualify for the capital that you must have to continue your business.

I have a generic concern about what interest rates do to our small business community. But I have a very specific concern about women-owned small businesses. As you know, women-owned small businesses are growing at twice the rate of male-owned small businesses. And they have, and this surprises many people, they have a lower bankruptcy failure rate than male-owned small businesses. In spite of that very good track record, availability of capital is a very serious problem for women-owned small businesses.

My concern is that as our small businesses get squeezed with increasing interest rates, how are we going to make sure that our women-owned small businesses are not squeezed more than male-owned small businesses. Because of the present, and I am afraid for the moment at least, continuing attitude of the lending community that women are not as good a risk as men in terms of managing businesses, when in fact the record shows that they have a lower bankruptcy failure rate than their male counterparts. Can you comment, please?

Mr. FERGUSON. There are a couple of comments that one would make. First, as you well know, there are a number of laws on the books that outlaw discrimination of any sort in extending credit. And I think it is quite important for those who are responsible to make sure that those laws are fully enforced.

I would raise a second issue because I think you have touched on a very important topic, which has to do with what I would describe as financial literacy. And the point that you have made that I find so telling is that financial literacy we often think of as having to do with individuals and households and high school students, etc., but it is equally important for bankers to understand the credit risk of their counterparties and to judge credit extensions based on a fact-based analysis, not based on any unusual agenda or color or things that are inappropriate.

And so I think raising the degree of awareness, as you have just done with the facts that you have brought forth, is very, very useful. So I sense that indeed just having honest discussions of this sort about the characteristics of small businesses, what one can say about profit, profitability, creditworthiness, etc., all of those factors should come into play.

But when all is said and done a good banker, exercising what I describe as basic banking skills, will understand well the creditworthiness of counterparties, price the risk appropriately, deliver the appropriate amount of capital, and should be able to overcome some of the concerns that you have just talked about. And our job in part, back to an earlier question, is to encourage bankers to be responsible, to be prudent, to exercise basic banking judgments. And if they do that they ought to be able to sort out the creditworthiness of their various sorts of applicants and make the right kind of decision.

Mr. BARTLETT. Mr. Chairman, I would like to suggest that perhaps the best thing that Congress can do to help small business is to reduce the size of government and spend less money, which means we need to borrow less money, so therefore we compete less in the marketplace for borrowing money, and that will drop interest rates. I think there is probably nothing else that we could do that would be so helpful to our small businesses as reducing the amount of money which we spend.

Chairman MANZULLO. You don't expect a comment on fiscal policy from Dr. Ferguson on that, do you?

Mr. FERGUSON. I think that comment was addressed to his Committee, his fellow Committee members.

Chairman MANZULLO. That is correct. That is correct.

Congresswoman Millender-McDonald.

Ms. MILLENDER-MCDONALD. Thank you, Mr. Chairman, and Ranking Member. Thank you so much for this very insightful presentation by Mr. Ferguson.

And, Mr. Ferguson, your testimony was quite impressive. I want to go back to what you mentioned to my friend on the other side there in stating that bankers should be cognizant of their lending partner, for lack of how you described that. Have you talked with bankers so that they will be sensitive to, i.e. women-owned businesses that are really the growing businesses in this country, and whether or not they subscribe to what you have just said in terms of making sure that they recognize their partner? Have you talked with bankers about this?

Mr. FERGUSON. I talk to bankers quite frequently in large groups and small groups. And, indeed, in almost all the speeches that I give I do talk about the importance of what I have described as basic banking skills, which includes making creditworthy judgments.

We should be clear. I want to take a step back because I want to bring some science, if you will, some economic science to this discussion I have just had with the two of you. There have been a number of economists who have looked at lending, lending behavior, particularly with respect to small businesses. And overall the evidence on the question of discrimination with respect to lending to small businesses is what economists describe as ambiguous, which is to say it is really hard in the data to find concrete, consistent support for the comments that have just been made about discrimination in lending.

So you should be aware that economic scientists have been sensitive to the issue, have been looking at this over many, many years going back to when I was in school and certainly probably even before, and the results are, as I say, quite ambiguous. And that suggests obviously some ongoing vigilance and enforcement of laws. That's important.

Ms. MILLENDER-MCDONALD. Why has it been ambiguous?

Mr. FERGUSON. Well, I think the reason that it has been ambiguous is, first, depending on how you cut the data there may or may not be evidence of differences in prices. While I recognize that there are people that feel quite strongly that that is the case, if one looks at large panels of data, it doesn't always show up as quickly, as clearly as one might like.

The second is that one has to really control for all the factors that a bank can appropriately take into consideration in making a loan. And, indeed, particularly in the world of small businesses, as you well know, they come on the scene quickly, and have a relatively large demise as well. So it is often hard looking at a small business to have a strong sense of how viable it is going to be. And that is a legitimate question for a banker to take into consideration. But it is very hard for an economist after the fact to determine what the banker might have seen at the time that the credit decision was being made.

And then we also discover, for example, that a number of small businesses avoid applying for credit just as a general matter. And it turns out that minority- and female-owned businesses are more likely to avoid applying for credit. And you cannot tell quite what——

Ms. MILLENDER-MCDONALD. And why is that? And why is that, sir?

Mr. FERGUSON. Well, that is the point, we cannot tell quite why that is the case. We do not know——

Ms. MILLENDER-MCDONALD. And that is why——

Mr. FERGUSON [continuing]. We do not know if it is out of anxiety about the concerns that you have just raised or if there are some other perfectly legitimate reasons why they might be avoiding it.

Now, let me get back to this. Recognizing this deep ambiguity that exists in the science, I think it is our job to continue to raise the importance of enforcing laws that are currently on the books. It is our job, I think, to remind banks of the appropriate basic business skills, to look at creditworthiness. I think it is frankly the job, as you have done, to ask people about this, to keep this as an important topic so that we can continue to try to make inroads and make sure that the credit is extended based on the right kinds of criteria.

So the fact that the science has not yet proven it does not mean that we shouldn't continue to encourage the right kinds of behavior, and that certainly means that we should continue to vigorously enforce the laws that are currently on the books.

Ms. MILLENDER-MCDONALD. It seems to me like the ambiguity that you have just mentioned certainly should be of some concern to the Federal Reserve or at least speak to the banking industry as to why is it that women and minorities are not rushing to trying to find or trying to seek those loans. And as you said about the control of the data that makes it ambiguous, that is another concern that I have. But that is another time I suppose because I wanted to ask you some more questions here.

Mr. FERGUSON. Let me respond to another point you have made. One of the other things that the Federal Reserve does is that we have very active community development activities around the country run by our various Reserve Banks. One of the goals there, one of the things that does emerge in those activities, and again we are not trying to allocate capital but raise the degree of conversation if you will, is to help bankers understand how to think about lending in a variety of different sorts of communities. And so, you know, we clearly at our Reserve Bank level have active programs again enforcing laws that are currently on the books but thinking through questions of community development. And one of those questions obviously has to do with do bankers fully understand how to look at and work with a variety of different types of borrowers?

So I would say that the fact that the data have not been clear on this has not in any sense stopped us, either through comments that we make, through the enforcement of the law, or through the active behaviors of our 12 Reserve Banks, from focusing in on the kinds of issues that you are currently raising.

Ms. MILLENDER-MCDONALD. Mr. Chairman, I have just got to ask Mr. Ferguson. You laid out some data here when my colleague spoke with you, and you spoke about that data in rounds of small businesses. Now, do we differentiate between small businesses and small manufacturers? Aren't we talking about manufacturers today as opposed to small businesses or are they all encompassing? Because your data, as I heard, was strictly on small businesses and the notion why this interest rate is proposed, increased interest rate.

Mr. FERGUSON. I am not discussing specifically interest rates. But the testimony itself attempted to parse out data where we know about small manufacturers versus small businesses. So we have worked hard to try to do that.

Now, one of the points I did make in the testimony is that the nature of this downturn that we experienced last year was unusual for a number of reasons but it hit the manufacturing sector particularly hard. And I think, as I have said in the testimony——

Ms. MILLENDER-MCDONALD. Of course it did.

Mr. FERGUSON [continuing]. That is an important background fact to have as one thinks about credit, credit extension, creditworthiness, is that indeed manufacturing then, small manufacturing——

Ms. MILLENDER-MCDONALD. Of course, yes.

Mr. FERGUSON [continuing]. Was uniquely influenced by the slowdown last year.

Ms. MILLENDER-MCDONALD. And this is the climate by which you increase interest rates as opposed to not, given that type of scenario you have just outlined?

Mr. FERGUSON. I think the Chairman wants to say something. Yes, sir?

Chairman MANZULLO. Well, I would like to get Congressman Phelps, make sure his questions are in, and then perhaps we might have one or two other questions and wrap up. Okay, but thank you, sir. Before you leave, it is obvious that Dr. Ferguson is open to all types of data, studies, measurements, etc. And if you come across in your journeys a specific type of indicator, bring it to my attention and Ms. Velázquez. We would love to work with you and send a letter to Dr. Ferguson because he looks at it. Anything that we send him they take a look at.

Thank you.

Ms. MILLENDER-MCDONALD. I would do just that, Mr. Chairman. I do have a statement for the record. Thank you.

[Ms. Millender-McDonald's statement may be found in the appendix.]

Chairman MANZULLO. That will be made part of the record. Congressman Phelps.

Mr. PHELPS. Thank you, Mr. Chairman.

Dr. Ferguson, thank you for your valuable input. Just to follow up on one of the themes. And maybe you stated this. I came in a little bit after the middle of your statement, and I have not read it all. Why do you think the recent recession had a disproportionate impact on the manufactured goods rather than other sectors of our economy?

Mr. FERGUSON. I think that in the nature of the downturn last year, the slowdown last year, two things occurred. First, early on in this process of adjustment, I think businesses decided that the outlook in terms of sales was not as optimistic as they had originally thought. And, therefore, they decided they wanted to reduce their inventory. Well, by definition, inventory is goods, it is not services. We don't have inventories of services, it is goods. And because it is goods it tends to be by definition manufacturing that ultimately feels the brunt of a decision by any business to reduce inventory.

The second thing that made last year's downturn unusual was that it followed a period of very rapid investment, particularly in high-tech capabilities, in communication equipment, computation equipment, etc. And, again, what we saw was quite a change in investment appetite for businesses so that high-tech manufacturers, not just manufacturers in general but high-tech manufacturers, were heavily influenced by last year's slowdown.

And so I think the reason that manufacturers were disproportionately influenced by the slowdown has everything to do with the nature of the slowdown being focused on inventory and inventory adjustments and also relatively dramatic changes in investment and investment intent by businesses.

Mr. PHELPS. Thank you. Just as something I have run across, and it is not a question, just a comment. Many of the smallest of the small businesses I have found, especially in small rural areas where I represent largely, do not really even attempt to access capital through the banking systems because they are so small that many times of course the SBA with their minimal $50,000 program, so many of these businesses return their own profit back into the business and circulate that sort of activity to operate.

So I am not sure we have a system or could how we monitor those types of the smallest of the small businesses that are not even participating in the banking activity but yet create two or three or four jobs there or are self-employed for the most part, pay their own health insurance. Those are steaming, they contribute to the economy also. But yet, I do not even know how we try to deal with them. And I have sat down with many of them in their own little mom and pop shops that really contribute to the economy in many invisible ways. And I am not sure how we could ever get a handle, but they tell me the reason; my point is they tell me they don't try to access capital because many of them are right on the margin of growing to another level but what they would anticipate in that profit and what they would have to pay in interest rates even at the very lowest just does not make it worthwhile.

That's a unique phenomena.

Mr. FERGUSON. It is unique. There is nothing much I can add but you are absolutely right. The range of things that we describe as small businesses include some that are really, for lack of a better word, microenterprises and extremely small.

Mr. PHELPS. Right.

Mr. FERGUSON. Many of them as I have thought about this and looked into it are self-financed from their own cash flow or from relatives and friends, etc., and are not big enough or do not feel the need to try to find capital by going into the banking system.

Mr. PHELPS. Which says something for the management skills at the same time. If all of us were that good, we probably would not need the banks then we would have another problem, wouldn't we.

Thank you very much.

Mr. FERGUSON. Thank you.

Chairman MANZULLO. I am going to exercise my prerogative as Chairman and ask a concluding question.

Doctor, we, several months ago we had a roundtable discussion with small business people that are concerned about the lack of credit. And we discovered an interesting phenomenon going on, and that is that the small business people, who are really the entrepreneurs of the world, are financing their business operations on credit cards, on introductory rates of .9 percent for three months or six months, then they roll it over to the next one, pay it off. And it was some phenomenal testimony as to this unique system of financing which works all the time because of the abundance of credit cards.

Is there any indicator that exists as to the amount of credit card debt that would be attributed to entrepreneurs getting capital at very low prices?

Mr. FERGUSON. Well, as I said, we do these surveys of small business finance, and that survey does have some information on it with respect to types of external financing services used, as that is called.

Chairman MANZULLO. External financing?

Mr. FERGUSON. Right. And that includes checking accounts. It includes credit cards, as you just talked about. It includes loans of one sort or another. So, indeed, as we go out and do the surveys, we do try to track the kind of information that you have just talked about.

If one looks at the sort of periodic information on credit cards, there is obviously more frequent information on cards, but the ability to tell from the sort of the week to week information about credit outstanding, how much of revolving credit, which is credit card credit, is being used for small business purposes versus individuals, that is hard to say.

So our survey data is the place where we find most of the information on credit cards. And we take those surveys periodically and then that is the best information we have.

Chairman MANZULLO. Thank you very much. Again, I want to thank you on behalf of the Full Committee for your taking the time to be with us this morning and look forward to working with you and look forward to hosting you in Rockford, Illinois, where we can show you the sweet smell of machine oil.

Thank you, Dr. Ferguson.

Mr. FERGUSON. I am looking forward to it. Thank you.

Chairman MANZULLO. Appreciate it. Thank you.

The second panel is here. And I would like Congressman Davis to introduce a constituent of his, who is with us today.

Mr. DAVIS. Thank you very much, Mr. Chairman, and Ranking Member Velázquez. It is my pleasure to present to the Committee Mr. Howard Habenicht, who is President and CEO of Vibro/Dynamics in Broadview, Illinois. Of course Vibro/Dynamics, which was established in 1964, manufactures vibration isolation devices and other machinery, installation systems for metal forming, metal cutting, forging, can making, die casting, plastics, woodworking, and textile industries.

It is a delightfully small community where his plant and facility are located. They are a thriving industrial-based community. And we are just delighted that he is able to be here today representing the National Manufacturing Association.

Welcome and thank you so much.

Chairman MANZULLO. Okay. The first witness will be Dr. Michael Czinkota. Your name is Polish, mine is Italian, all right? I will do the best I can on these names. I appreciate that, Matt, but my gosh. We could call you Dr. Smith. I mean that would make it a lot easier.

Dr. Czinkota is professor of international business at Georgetown University, McDonough School of Business in Washington, D.C. And he has been a special advisor to a project that we have been working on ever since we got it back from China called America's Jobs First, sitting in on meeting after meeting making sure that we stay on course in order to increase America's exports.

Dr. Czinkota, look forward to your testimony. We have the red light here. When it gets to yellow, that is one minute to go. When it gets to red, that means time to conclude. So we would appreciate if you could follow that. Look forward to your testimony.

The complete statements of all the witnesses will be made part of the record.

If you could pull the mike a little bit closer to you, Doctor, I think it would be a lot easier to hear. Thank you.

STATEMENT OF MICHAEL CZINKOTA, PH.D., PROFESSOR OF INTERNATIONAL BUSINESS, GEORGETOWN UNIVERSITY McDONOUGH SCHOOL OF BUSINESS, WASHINGTON, D.C.

Mr. CZINKOTA. Thank you very much, Chairman Manzullo, distinguished members of this Committee. I appreciate your inviting me to testify here today on U.S. exporters in the global market place. I base my comments on the more than two decades that our international marketing team at Georgetown University has systematically tracked the activities of international firms.

The news for the U.S. trade position and for small to medium size U.S. exporters is not good. Large trade deficits, which in 2001 reached $426 billion for trade and goods, are unsustainable in the long run. That makes it increasingly critical to achieve an export performance that matches and exceeds our imports.

Exports are also an important contributor to national employment. Over eight million jobs are sustained by the exports of manufactured goods. In Illinois alone, for example, more than 360,000 jobs are linked to exports.

U.S. exporters are vulnerable in their export performance and expansion. Small and midsize U.S. manufacturers encounter four major problem areas: financial issues, supply chain management, regulatory issues, and market contact difficulties.

On the financial side, international transactions are more costly than domestic ones. This is due to the time lag between shipping and payment receipts as well as to the need to offer credit to buyers. At the same time as they need more funding, our exporters are encountering a tighter credit market and the threat of higher interest rates.

Unlike larger firms, our smaller companies cannot boast of access to global capital markets. Their transactions are too small and their collateral processes are too limited. As Mr. Ferguson already has stated, typically they are reliant on local financing alternatives, and therefore they suffer from local interest rate inefficiencies.

Exchange rate changes also make smaller manufacturers vulnerable since they are not prepared to adjust to such shifts by serving new markets. The low value of the European currency, the euro, makes it easy for importers but tough for exporters to compete. Please consider that there is an increasing commoditization of goods where price is the decisive criterion in getting the order. Any upward swing in price, be it due to exchange rate changes or interest rate shifts, even if seemingly minor, can have a major effect on a firm's performance abroad.

Government regulations, such as export controls and customs rules, often extract a high price of compliance from smaller size firms.

Firms are also exposed to a double-whammy from trade policy. For example, in the steel case, many of our smaller firms must now pay higher prices for their steel-based input while at the same time their export efforts are exposed to retaliatory action by trading partners.

Due to the threat of terrorism, our firms also need to be much more vigilant in their supply chain management. Security measures require them to redesign their just-in-time systems. Higher transportation and insurance costs force them to revamp their way of transporting supplies and bringing them to market.

All these shifts make it difficult for firms to compete abroad. It bears remembering that any firm that newly enters an international market must not only match but must by far exceed the capability of the local competition in order to be successful. We need to provide our firms with a stable financial environment both domestically and internationally. Low interest rates empower our firms. A responsible relaxation of some of the stringent credit criteria would also be of help, as would encouragement and support of marketing and distribution based investments. Unless our firms can make such investments into the international presence and processes, they will not compete successfully.

We need to have more work done on generating data-driven insights so that we know which policies help and which ones hinder the performance of firms. The development of a globalization index which measures the extent to which countries are linked to the world could be of major use to firms. Increased collaboration of federal agencies with trade and professional organizations is also important in supporting the tough tasks that our exporters face.

Overall our smaller size manufacturers still have many hurdles to overcome on the way to increased exports. They need to be able to fight and win the battles of competition in the international marketplace.

On the policy side we need to ensure that our firms have a strong, healthy, and competitive platform from which to launch their international ventures. After all, economic performance and success are the key foundation to our global position and our national security.

Thank you for your attention.

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

Chairman MANZULLO. Thank you.

Our next witness, it is my pleasure to introduce is my constituent. Don Metz is Vice President of Metz Tool and Die Works in Rockford, Illinois. And Don and I have known each other for a long period of time. He represents the old world manufacturing base that I referred to, but I left out the fact that it is not only the Swedes that settled the area, but it is the Germans.

Mr. METZ. That is right.

Chairman MANZULLO. With their high-technology and the families going back for different generations.

Don has worked with us. And I don't know how many government people that he has met in efforts to expand his horizons and to keep the shop profitable, keep the people employed. And, Don, we are honored you came all the way from Rockford, Illinois, to testify to us today. We look forward to your testimony.

STATEMENT OF DON METZ, OWNER/PRESIDENT, METZ TOOL & DIE, ROCKFORD, ILLINOIS

Mr. METZ. Thank you.

Good morning. Good morning to all of you, Mr. Chairman, members of the Committee. I am here today to represent and testify to you on behalf of the National Tool and Machining Association and our 2,500 members spread across this nation. I want to talk to you for just a few moments about the negative impact that raising interest rates would have on our industry.

It was June of 1976, and I was introducing President Ford to a meeting of the National Tool and Machining Association in Illinois. And that night, the country was gripped in a recession, and these people were despondent, discouraged, and a little bit fearful. And President Ford stepped to the microphone in front of that group and he said, "I am absolutely convinced that this country, because of its people, because of its structure of government, because of the policies we pursue, will meet and conquer this challenge."

Well, the challenges for Metz Tool & Die began 55 years ago when my parents, Jim and Betty Metz, left their family-owned farms on the Missouri-Arkansas line to come to northern Illinois to seek their version of the American dream. They were armed simply with a faith in God, a willingness to sacrifice, and a belief that hard work would pay dividends. My dad started as an apprenticeship mold maker, and the Swedish and Italian mold makers were his role models. And after years of hard work and working two jobs and saving his money, he opened the first Metz Tool & Die in the garage behind our house.

I joined the workforce at the age of six and worked for 40 cents an hour. And believe me, I was overpaid. But as time went, with loyal customers, fair competition, and dedicated workers, the next 40 years brought prosperity and expansion to that industry and to that business.

But mold making is a business of precision machining. And if you ask; what is a mold maker? A mold maker is a sculptor. He is the artist in steel. He is the visionary that takes your dreams of a new product and turns it into reality. Mold making is everything that is mass-produced, from the first rattle you shake as a baby to the decorative hardware on your casket when you are laid to rest, begins in our industry.

And our industry meant more to me than just a business. My son, Matthew Metz, only lived 16 years. And those 16 years were spent in a wheelchair because he had Duchenne's muscular dystrophy which is, of course, the disease Jerry Lewis does a telethon for. Now, in that time you need lifts, wheelchairs, special beds, all sorts of special equipment. And I always turned to my dad, the mold maker, to tell us how to adapt that equipment to Matt's handicap.

One day I was agonizing over how to fix a particular bed for Matt's use. And Matt said to me, "Don't worry about it, Dad, Grandpa will figure it out, he's a mold maker. They can make anything." But mold making, die making, our industry has faced a new enemy in the millennium. It's offshore.

Companies have been lured offshore by the promise of cheap labor, low taxes, few environmental regulations, and they have left our markets. Motorola is the classic example in our district. Motorola came in with the promise of many jobs and millions of dollars in subcontract work. Well, now Motorola has chosen to go offshore, the jobs are gone, and the millions of dollars of subcontract work are now gone.

Our community suffered through the 1980s with a 25 percent plus unemployment. And we feel like we are moving back into that same range again.

I have had in the last two years the opportunity to travel and talk with some of my constituents and contemporaries. I walked down the halls of one shop, and the man showed me that there was a $100,000 CNC machine sitting empty for lack of work. Farther down the hall was a $300,000 machining center sitting empty for the lack of work. The walls were lined with the benches that used to house the tools of mold makers and die makers and machinists, but because business is off 30 to 40 percent, they were no longer working.

One man related the story to me of how he raised his business up from the very beginning. And he built it into a prosperous business. And he told his sons, you go off to college and get an education and when you come back take my business to the next level.

The sons went off to college, they got an education. And they came back. But when they got back, there was very little business there because the business had gone offshore. But yet understand, even when business drops off mortgage payments, interest payments, principal payments, workers' comp medical insurance, fire insurance, all these things keep coming. Suppliers don't sell there. Rubbish people don't pick up there. People don't bring uniforms there because business is off 30 and 40, 50 percent.

How can you help us? One, pass the Association Health Plan bill. That would give us insurance for our people at a competitive rate.

Give a Skilled Workforce Enhancement Act to bring the apprenticeship training back to our industry, a $15,000 tax credit.

Low cost equipment loans.

But most important, keep interest rates at their current levels because when interest rates are low, then we have the opportunity for new products. And new products create jobs. And when interest rates go up, new products are shelved, are forgotten, and then we lose jobs.

You have heard it said that the economy is rebounding. I hope you understand that I am saying our industry has not made it back yet. And our industry needs more time.

Last but not least, think America first for all your subcontract work.

Thank you very much.

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

Chairman MANZULLO. This has been one of the finest hearings that we have had in many—we have had, what, 45, 50 hearings together. And I tell you, you guys are making an impact, you ladies and gentlemen are making an impact. You know, from the Midwest we all say guys. I don't know why we do it.

Thank you for your testimony, Don.

Our next witness is, is it Fedor?

Mr. FEDOR. Fedor.

Chairman MANZULLO. Fedor. He is the President of MASCO Machine, Incorporated, testifying individually and on behalf of his association, the Association for Manufacturing Technology. I look forward to your testimony.

STATEMENT OF EDWARD FEDOR, PRESIDENT, MASCO MACHINE, INC., CLEVELAND, OHIO

Mr. FEDOR. Thank you. Good morning.

Let me begin by thanking you, Mr. Chairman, for your strong leadership along with Congressman Neal of Massachusetts of the House Machine Tool Caucus, which has provided invaluable support and encouragement for our industry.

I would also like to thank you and the members of your Committee who supported the economic stimulus package recently signed into law by President Bush. The 30 percent expensing provision included in the package gives my industry a real shot in the arm that we so desperately need right now.

Masco Machine, my company, is a small, family-owned designer and builder of custom metal cutting machinery. We have 60 employees. And we provide production equipment to the automotive industry, their suppliers, heavy equipment, agriculture, aerospace and other industries.

It is a cause for concern that the U.S. machine tool industry, an industry critical to national security and economic stability, is experiencing the worst market conditions in its domestic market since the Great Depression. Orders are off more than 50 percent since their peak in 1997. Import penetration has shot up nearly 20 percentage points in the past three years due to the Asian financial crisis and the weakening of the euro and the yen. Moreover, we have seen increased overseas and domestic outsourcing by some of our largest U.S. customers.

Since the slowdown in manufacturing started in late 2000, my company's sales dropped off by as much as 50 percent compared to our sales in the late 1990s. We have had to lay off 16 percent of our workforce, reduce hours, reduce employee benefits and cut costs in other areas. And it looks like, Lord willing, hopefully we won't have to lay off more people but we will see.

Unfortunately, almost all of our peers have had to do the same or more simply to stay in business. And we have lost a number of our very important peers in the last couple of years.

Over the past year-and-a-half, the Federal Reserve has responded to the economic downturn by cutting interest rates 11 times. And this policy is starting to show results. However, tight bank regulatory standards have resulted in credit being diverted from privately held companies, and many banks have raised their fees or their collateral standards or both, which has the effect of negating the effect of lower interest rates from the central bank.

To compound this credit crunch the dollar has been at record highs. This has had a devastating effect on my industry, effectively adding a 25 to 30 percent tax on U.S. machine tool products. This is an added cost that no degree of cost-cutting or productivity can overcome.

Recently my company participated in an online reverse auction for an automotive customer where we were competing with two German companies and two U.S. companies. Our equipment was priced absolutely as low as we could go. The overvalued dollar, undervalued euro permitted our European competitors to undercut our pricing by 30 percent. There is no way for us to compete with such price advantages.

Once market share is lost, it is very difficult to regain it. In almost every case our foreign competitors are strongly supported by their government. At times it seems our government is working against us. U.S. export control policy, particularly with regards to China, is a good example. Repeatedly over the last decade the United States Government has taken a negative approach toward machine tool sales to China while our allies have not. The result has been that the Chinese have been denied nothing in terms of high-technology while U.S. firms have lost out in a crucial market.

My company bid on a piece of equipment for legitimate end user, and the export licensing process took 11 months to complete. The whole process appeared to me to be biased toward refusing a license without ground. This effectively shuts us out of many potential orders in China and deters potential customers from even contacting us in the first place.

Mr. Chairman, our industry was hit extremely hard by this economic downturn. It battered manufacturers first. And the downturn has been sustained for nearly two years. We only see modest relief coming and not until well into the second half of this year.

I would note, Mr. Chairman, that if the United States were to use our domestic core of the machine tool industry we would become wholly dependent on our allies and trade competitors for the industrial production machinery that fuels our productivity and keeps our industries on the cutting edge of the latest technology. Without sensible government policies, the U.S. machine tool industry, which is critical to America's continued leadership, may be lost. Our industry supports your work and hopes to continue to work with you in your efforts to build a stronger America.

So we thank you, Mr. Chairman. And I would be happy to respond to questions.

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

Chairman MANZULLO. Thank you.

Our next witness has already been introduced. You would think I would be able to pronounce his last name after hearing it several times. Is it Habenicht?

Mr. HABENICHT. That is correct.

Chairman MANZULLO. That is Italian for "good food"?

Mr. HABENICHT. That is German for "have nothing."

Chairman MANZULLO. We need a more positive spin on it, you know?

Mr. HABENICHT. Right. I have had to live with that name all my life.

Chairman MANZULLO. What would be German for "abundance"?

Mr. HABENICHT. I am not German. I do not know.

Chairman MANZULLO. Oh, okay.

Mr. HABENICHT. I am an American.

Chairman MANZULLO. We look forward to your testimony. Thank you.

STATEMENT OF HOWARD HABENICHT, PRESIDENT/CFO, VIBRO/DYNAMICS CORPORATION, BROADVIEW, ILLINOIS

Mr. HABENICHT. Thank you, Mr. Chairman. I appreciate the opportunity to testify before your Committee today.

As you said, my name is Howard Habenicht. I am President and Chief Financial Officer of Vibro/Dynamics Corporation. We are a member of the National Association of Manufacturers, an association with 14,000 member companies. And included in that are 10,000 small manufacturers.

Vibro/Dynamics is located in Broadview, Illinois, which is just outside of Chicago. And we manufacture mounts and mounting systems for the installation of industrial machinery. We have about 30 employees but we are recognized as the leader, technological leader in the installation of metal forming presses in the United States. About 80 percent of our business is in the United States and Canada with about 20 percent exports.

As has been repeated today, the manufacturing sector was hit much harder than the rest of the economy during last year's recession. In fact, the manufacturing downturn actually began fully six months prior to the official start of the recession in March of 2001. It is the first time such a thing has happened since the end of World War II. And in setting the stage for a recovery in 2002, one of the most important elements is to be able to maintain low interest rates. This is especially important for small manufacturers like Vibro/Dynamics. While large firms have wide access to capital through bond and equity markets, small firms rely almost exclusively on the banking system for capital.

The 2001 manufacturing recession was caused in large part by a combination of high capital costs and zero pricing power. Belatedly, the Federal Reserve cut interest rates aggressively in the beginning of 2001. And as I speak now the federal funds rate now stands at a 40 year low. But any move by the Federal Reserve to increase interest rates at this point could derail the recovery that hopefully is just beginning to emerge.

Adjusting for inflation the real cost of borrowing for firms, measured as the nominal prime rate less inflation, is actually still 20 percent above its 40-year average. And we do not need it to go any higher. Moreover, no meaningful signs of inflation exist.

With inflationary pressures absent this is the wrong time to argue for higher interest rates when manufacturers are just emerging from the worst recession since 1982.

Now let me talk about the effects of the overvalued dollar which is decimating much of U.S. industry and certainly has hurt our company. In my company we have had to reduce our workforce by 30 percent and impose 10 percent pay cuts to everyone else. Last year was the first time in our 36-year history that we lost money.

In the last 10 years we have seen a significant decline in our customer base which is the U.S. machine tool manufacturers. In December of 2000 the only surviving U.S. builder of large presses, and at that time our largest customer, went bankrupt. The large press builders, and I am talking about builders of machines that weigh in excess of 4 million pounds up to as much as 10 million pounds, these builders are now found in Germany, Japan, and Italy. There are none in the United States. This has shifted our focus to overseas markets and manufacturers as these machines now are imported in the United States.

Because of the overvalued dollar, we find that we simply cannot match the prices offered by our overseas competitors and are now actually looking at purchasing some of our component parts overseas at costs much less than what it costs us to purchase in the United States. And this kind of action will lead to even more lost manufacturing jobs in the United States.

I believe in fair trade and fair competition. We have the best workers in the world right here in the United States, and our productivity continues to outpace that of other countries. Unfortunately, we cannot make up for a dollar-induced surcharge of 30 percent. And we are not alone. The National Association of Manufacturers using U.S. Government data has found that U.S. manufactured goods exports have fallen $140 billion in the last year-and-a-half. This is astonishing. In effect, our association estimates that this decline, principally due to the overvalued dollar, is so large that it has accounted for two-fifths of the entire decline in U.S. manufacturing employment, four out of every ten unemployed factory workers.

I am not a monetary economist. I am trying to run a company. But I know it is time for the U.S. Government to stop extolling the virtues of a strong dollar at any cost and start advocating and working for a realistically valued dollar.

Thank you for your attention.

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

Chairman MANZULLO. Thank you very for your testimony.

The next witness is Sara Garretson from the Industrial & Technology Assistance Corporation. And we look forward to your testimony.

You might want to pull your mike a little closer to you.

STATEMENT OF SARA P. GARRETSON, PRESIDENT, INDUSTRIAL AND TECHNOLOGY ASSISTANCE CORPORATION, NEW YORK, NEW YORK

Ms. GARRETSON. Thank you, Mr. Chairman and Vice Chairman Bartlett. And I hope we will see the Ranking Member Velázquez coming back.

I am Sara Garretson, the President of ITAC, the Industrial and Technology Assistance Corporation. We are a not-for-profit economic development organization located in New York City. Like all of the 60 Manufacturing Extension Partnership or MEP centers across the country, we help small manufacturing firms in our locale to be more productive, competitive, and profitable.

The manufacturing sector is important to our nation's economy. It contributes 16 percent of the gross domestic product. Employees earn $44,778 average annually, which is 27 percent higher than the U.S. average for all industries. 80 percent of U.S. export revenue is manufactured goods.

The small manufacturer is a key component of our nation's industrial base. There are over 355,000 of them in the U.S., making machine tools and molds, but also making parts for Boeing and G.M., producing food for our markets and products for our retail stores as well as for export. 95 percent of all U.S. manufacturers are small firms. They provide employment for 11.3 million Americans, two-thirds of total manufacturing employment.

Almost ten years ago, I participated in a National Research Council Study entitled "Learning to Change: Opportunities to Improve the Performance of Small Manufacturers." The study identified five barriers to manufacturing performance improvement in small firms. One of these was the scarcity of capital. The study found that small manufacturers lacked access to operating capital and investment funds for modernization.

Has this situation changed? Well, recently the National Association of Manufacturers completed a survey on credit rationing. One of the survey's conclusions was that, and I quote, "More than a third of small and medium size manufacturers are finding it more difficult to obtain credit from their longstanding bank lenders—a trend that threatens to undermine our economic recovery."

Why does this matter? If we are to recover from the current recession, then we need small manufacturing firms to improve their productivity and to develop new products and markets. These firms can drive the recovery, but only if we give them the means to do so.

Investments in productivity improvement and in product development pay back year after year. Would firms actually invest in productivity improvement if they could access the financing at a reasonable cost? Another recent NAM survey showed that over 75 percent of small manufacturing firms want to invest in their future, including marketing and sales, manufacturing process improvement, product development, and workforce training.

At ITAC, as with other MEP Centers, we frequently witness the payback of these investments. In my written testimony, I gave two examples from Congresswoman Velázquez' District. I think I have time for one today.

Grand Processing Inc., formerly known as Tony's Brushing and Processing, services the local textile knitting industry by dyeing and drying textiles. They employ 75 people. In today's market they are expected to provide high quality and 24-hour turnaround. They came to us for help in reducing their very high energy costs and to reduce turnaround time.

We worked with the company to apply microwave technology in a whole new way to drying for textiles. When the installation becomes operational, the company will have energy costs at one-fifth the current level; the machine will dry the textiles in one-fifth the time, using one-fifth the labor.

The project cost $350,000 but, fortunately, we were able to help the company to access financing through a New York State government agency.

Before I close I want to say a few words about the Manufacturing Extension Partnership. As I am sure you are aware, the program is in danger of elimination because the proposed Administration Budget for fiscal year 2003 reduces funding from $106.5 million to $12.9 million. MEP is a cost-beneficial investment for the Federal Government. We return $4 in federal tax revenue for every $1 invested in the program. For fiscal year 2000 only, our client firms reported $2.3 billion in increased and retained sales, cost savings of $483 million, and more than 25,000 jobs created or retained.

In sum, our small manufacturers are an important part of our economy, past, present, and future. Our country and our economy need to make sure they have the means and the knowledge to invest in their future success. The MEP provides the technical support the firms may need to invest wisely and successfully, but the manufacturers also need to be able to access reasonably priced financing. Keeping interest rates low during this critical phase of the economic recovery will help to make the means available for these investment in the future.

Mr. Chairman and Ranking Member Velázquez, I thank you and the Committee for the opportunity to appear before you today. And I will be happy to answer any questions.

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

Chairman MANZULLO. Thank you very much. Excellent testimony of everybody.

I have a question I would like to ask of Mr. Habenicht. And, Professor, perhaps you could help us answer this question.

Appearing on page 5 of your testimony, right at the bottom, it says "one of the European press builders." Are you talking about newspaper press or what type of presses.

Mr. HABENICHT. No, no, metal forming equipment.

Chairman MANZULLO. Oh, okay.

Mr. HABENICHT. Punch presses.

Chairman MANZULLO. Punch presses. Okay.

"Had been telling their customers that if they used Vibro/Dynamics mounting systems for installing their presses, they would not honor their warranty." And even though this is not government action, Professor Czinkota, do you detect any type of violation of any trade laws by that type of activity taking place?

Mr. CZINKOTA. Well, it is always difficult to tell outside of having been there at the specific situation. But clearly in terms of procurement code which would encourage transparency and equal access to contracting, one could and possibly should look at that more closely.

Chairman MANZULLO. But this was a private company here.

Mr. CZINKOTA. Nonetheless, we like to think that the procurement code, even though it focuses on government procurement, also tacitly expanded to reasonable actions on part of the private sector.

It is the type of thing where you cannot bring down the brunt of trade law but you certainly can bring down the force of persuasion in trade discussions.

Chairman MANZULLO. Did you want to comment on that?

Mr. HABENICHT. Well, we thought it was very mean-spirited, if nothing else.

Chairman MANZULLO. At the bottom, right. But that happens, but it sometimes means there are things illegal.

Mr. HABENICHT. But that is, yes, that is something that happened several years ago. And since that time we worked very hard with this company. And as I indicated in the written testimony they do now allow us to quote on their machines. So that particular negative thing that was happening is not happening anymore.

Our big problem today, as I said, is the surcharge that we are faced with because of the inflated dollar.

Chairman MANZULLO. Okay. Then let me go right back to Dr. Czinkota. This is a tough one. You know, five years ago we were commending the Chinese for not devaluing their RMB during the Asian crisis. Now for five years it has been stuck at I think 8.7 to the fixed U.S. dollar.

Dr. Czinkota, how do you go about, I don't want to use the word devaluing the U.S. dollar, because that is what it is, but making the U.S. dollar more competitive overseas? Is the solution harder, or is the remedy harder than what the problem is? Appreciate your comments, it is a tough question.

Mr. CZINKOTA. Well, it sure is. And let me tread very lightly here.

First of all, obviously we need to keep in mind that if we are talking about currency change, there are different players. How you like it depends on where you sit. Importers, for example, are absolutely delighted about the low prices they are able to obtain abroad because of a strong dollar.

Now, our focus today is on the other side, namely exporters, and how can they penetrate international markets? And they are clearly inhibited by a strong dollar.

Now, the last policy occasion that we have had where there was a meeting and a subsequent decline of the dollar was really the Plaza Agreement in the late Eighties at which time the major trading players met, the secretaries of finance, in our case Treasury, met and looked at the world and tried to formulate a longer-term vision as to where do we go from here. And to some degree their pronouncements, even though backed up by some funds flow, also had a lot of psychological effect on the markets.

One problem we are facing today, if you want to call it a problem, is the U.S. has a very powerful attraction as a market and as a safe haven for money. So as a result, a lot of people abroad believe in our country, which is actually nice to know. But they accompany that belief by sending money here. And as they send money here and purchase dollars that means the value of the dollar remains very strong.

Chairman MANZULLO. You did not answer the question. Do you want to take a stab at it?

Mr. HABENICHT. I could take a stab at it.

Chairman MANZULLO. Is the remedy worse than the cure? Anybody. Okay.

Mr. HABENICHT. I think, I don't know a lot about how this stuff works, but I think one of the things that happens is when the dollar starts to fall in relation to foreign currencies, the Treasury Department goes in and starts buying U.S. dollars on the market to prop it back up. That is a simple answer and it may be oversimplified, but that is about the extent of my knowledge of how that works.

Chairman MANZULLO. Well, that says when the dollar starts to fall. But that has not happened.

Mr. HABENICHT. Well, you don't know it has not happened because when it does start to happen they take this action that raises it, they start to buy the funds.

Chairman MANZULLO. Well, there is another dynamic. It is not just that strong dollar is not just making it more difficult for American manufacturers to export, but it is direct competition for American manufacturers like Don Metz and Ed Fedor and Howard Habenicht to compete domestically because the people to whom they would ordinarily sell are buying the stuff on the open market internationally, displacing the domestic market on it.

Ms. VELÁZQUEZ. Mr. Chairman, would you yield?

Chairman MANZULLO. Please.

Ms. VELÁZQUEZ. Following the same line of question, Professor, could you answer, would most of the options for devaluing the dollar produce negative impacts on the domestic economy?

Mr. CZINKOTA. When the Fed has difficulties answering precise cause/effect relations then I am not sure I am the right one to present you with direct causality. Clearly you have different sectors being affected in almost diametrically opposed ways by a changing currency value.

Right now, of course, we import more than we export. That is why we have a trade deficit. So that would indicate that a larger sector, segment is affected. But at the same time, as the Chairman pointed out, there will be an effect on domestic producers as well due to the relief of pressure on them from imports.

But far be it from me to precisely delineate the outcome of that.

Ms. VELÁZQUEZ. Thank you.

Ms. Garretson, you spoke about the budgets proposed part of 89 percent to the MEP. And can you clarify or expand a little bit more in terms of that budget cut and would your center or most of the other 60 or 61 centers nationwide would have to be shut down?

Ms. GARRETSON. I think it is a combination of shut down and severely diminished capacity. The federal funding is structured in such a way that it requires a two to one match, which most of us receive through our states and also through local company cost share.

Some of that state funding is contingent on the federal money. So the federal money leverages a system that then puts 2,000 people out working with companies. You take that away, you are going to have some of that state money taken back as well.

For our organization, we have 12 "feet on the street" at this time, and I would suggest that means engineers and manufacturing professionals working with companies. We will cutback to two or three at most. Now, we have 10,000 manufacturers in New York City, so you can imagine that that then severely diminishes our ability to work with them.

Ms. VELÁZQUEZ. Could you talk to the Committee about the experiences that the manufacturers in Brooklyn and Manhattan have been facing after September 11? And, also, what have been the largest challenges that they have faced after September 11? And what do you think in terms of economic relief would be more beneficial for them, grants or disaster loans?

Ms. GARRETSON. Okay. I think there are two things that happened. One is that the economy had already slowed down. For the New York City firms, the economy just sort of plummeted on September 11. So one issue is the amount and the sudden occurrence of economic contraction. So many of the businesses that we are dealing with, are seeing a temporary reduction in sales, others experienced a permanent reduction in sales because they had customers who were in the World Trade Center.

Some firms were actually located in Ground Zero. And we are just starting to actually help a printer who has lost his facility and is having to relocate and start up again.

I think the other thing is a less tangible issue which is fear. It is a psychological issue: "Do I have enough confidence in the future of this city and of this location that I will invest in my firm's future?" And our sense is that we have seen great reluctance to do that. I am hoping that we are now beginning to see some changes in that. But companies who we have been working with for a long time have said, "No, right now I am not doing anything, I am waiting to see what is happening here."

So I see A) declining business, B) declining willingness to invest, C) uncertainty and the psychological impact.

Accessing the loan programs have been very difficult. Most of our businesses do not like giving a personal guarantee, particularly in an era when they are not confident in the future. They do not want to pledge their homes in this kind of uncertain environment. So that has been a tremendous barrier to people stepping up to the various 9/11 loan programs.

So the answer is, "it depends". There are cycles of impact, there are companies who lost their location and who really need grants, and there are others where if you loosened up the guarantee requirements, the financing might be adequate. These are the "secondary impacts" companies.

The "primary impact" companies are at all levels. Whether they are a retail store or a Law firm, the impact has been tremendous. We lost our space for a month and were forced to work "virtually". But it was more than a month's worth of impact. We are still trying to recover from that.

Ms. VELÁZQUEZ. But I think that you will agree with me that the same way that we bailed out the airline industry we could provide, the Federal Government, some grants assistance——

Ms. GARRETSON YES.

Ms. VELÁZQUEZ [continuing]. To small businesses?

Ms. GARRETSON. Yes.

Ms. VELÁZQUEZ. Mr. Metz, can you talk to us about how has the lack of skilled workers impacted your business? And how do you think it has impacted the entire tool and machining industry?

Mr. METZ. The skilled worker problem is a problem of confidence. In order to train a new skilled worker the National Tool and Die Association tells us it takes four years and about $200,000. So as margins are being cut and profits are not there, immediately one of the first things people begin to give up on, of course, is the apprenticeship training. Unfortunately, our industry is getting older. And the average mold maker in this country right now or die maker is 50 years old.

And these are high paid individuals who have made an awful lot of money in their lives, so at this point in their life, they are not as interested in still working at the same pace or the number of hours they used to. So you have a twofold problem: On one end you have your most skilled workers reaching a point in their life where they have the money and the kids are through college and they want to reduce their workload, but yet at the other end, you are not training new people because you do not have a lot of confidence in the future to go into that sort of an investment program.

So we need to jumpstart the apprenticeship program. And literally thousands of young men and women who qualify to be apprentices and to get that kind of training are being rejected not on their merit but on the lack of confidence that the industry has in its future.

Ms. VELÁZQUEZ. Can you tell us how the Skilled Worker Enhancement Act will benefit workers?

Mr. METZ. Well, I by no means believe that this act is going to answer all of the problems that the company has. But by giving a $15,000 tax credit per employee that you train, you give an incentive to the company owner to begin that process.

These people are astute enough to realize they are going to have to train somebody sometime. This is not going to be able to go on like this forever. And I think it sends a really positive signal to these company owners that the government understands their pain and is doing their best to address it. And you get more of a cooperative feeling that the government is in this with me, the government has confidence in me and in the future of my industry and, therefore, let us get back to the training program.

Ms. VELÁZQUEZ. Thank you.

Mr. METZ. Thank you.

Ms. VELÁZQUEZ. Thank you, Mr. Chairman.

Chairman MANZULLO. Thank you.

Mr. Bartlett?

Mr. BARTLETT. Thank you very much.

In a former life I was a small business person so I listened with great interest to your testimony.

Dr. Czinkota, you mentioned that our trade deficit last year was $426 billion. Now, more than 100 billion of that I think was with China. And most of the stuff that I see we are buying from China is going to be on the county landfill by the end of the year. It is not durable goods.

Help me understand how at least a large part of this $426 billion is not simply a transfer of wealth from our country to our trading partners?

Mr. CZINKOTA. There are several things to keep in mind with the $426 billion, which is the merchandise trade deficit. You are absolutely correct, a large portion of that is with China and with Japan as the second largest trade deficit country.

First of all, one hopeful benefit we are going to see with China is that now that the country has joined the World Trade Organization, its own market will open up much more and, hopefully, that means we can penetrate it. I am saying hopefully because I know that it will be more penetrated if they comply with the rules, but I hope it is not just European firms then who benefit from that. I am hoping that U.S. firms will be very strong in that penetration.

So that should account for more evenness in the exchange rather than what you call transfer of wealth.

The second issue to keep in mind is also that we are looking at an increasing proportion of intra-firm trade. What that means is U.S. firms are going to countries, setting up operations, producing there, and then importing from abroad into the United States. So the instigator if you will or the primary profit taker is actually a U.S. firm or a multinational firm from some other country, not necessarily just a Chinese firm even though foreign investment, of course, triggers domestic benefits.

And, finally, firms are responding to customer demands and to demands by their supply chains. If you look at, for example, our leading retailers who very specifically tell their suppliers that consumer goods have to be very low priced otherwise we won't carry your products, we carry someone else's. And that, of course, in itself triggers a lot of the imports from Asia.

Mr. BARTLETT. Our industry, of course, is moving from a manufacturing industry, which was our great strength for many years, it is now moving to a service-based industry. Now, if you push that to an absurdity you can see that we cannot survive. If all we did, for instance, was cut each other's hair, obviously that is not a basis for a viable economy, is it? At what point do we finally recognize that our economy cannot survive without returning to a vigorous dependence on a manufacturing base?

You know, there are only a few industries that produce wealth. Farmers produce wealth. Service-based industries are consumers of wealth. I used to be a producer of wealth, now I am a consumer of wealth. And manufacturing is one of the big producers of wealth and now that is progressively moving offshore. When are we going to understand that moving electrons around the country and cutting each other's hair and cleaning our clothes cannot be the basis of a viable economy?

Mr. CZINKOTA. Well, sir, first of all I am in full agreement with you that manufacturing is a terribly important sector of the economy. And I, for one, do not wish to see any kind of hollowing out of that sector.

Having said that, one blessed condition we have in the U.S. is that we do rely on market forces. And I would be happy to supply you with the data from, stemming from the turn of last century where we had about something like 60 percent of our domestic employment in farming which has now declined to about 2.5 percent. And the outcome, of course, is not that now we have all these unemployed farmers, but we have a tremendous shift in employment figures and lots of people are now employed in occupations different than farming. And this is not because anyone told them to or government told them to but because market forces have created new opportunities in other sectors.

Now, you are very correct in your statement on services. We have become a service-driven economy both in terms of percentage of GDP as well as in terms of employment. It is, of course, not just not all cutting hair. You also look at service jobs in the banking industry, in the construction industry.

My wife, for example, is an architect, and her work increasingly is global where she takes on architectural products, redesigning, restoring hotels in Singapore which would not have happened ten years ago. So in that sense there also is wealth generated by knowledge, by intellectual property. And I wouldn't give up on the services sector just yet. But the manufacturing sector clearly is and should remain a very important component of our economy.

Mr. BARTLETT. Thank you.

Mr. Chairman, traditionally our service-based industries have been supporting those industries that produce wealth. Today if they are supporting industries that produce wealth, they are supporting industries overseas that produce wealth, not in this country. Thank you.

Chairman MANZULLO. Let me if I could do a follow-up on that. We have about an $80 billion surplus in services. Under the WTO, under the U.S.-China WTO accords, the opportunity for exports and services to China is just, I mean it is wide open for everything, life insurance to banking to having American money managers manage portfolios in China. And for the first time that agreement is one-sided. That type of agreement is one-sided in favor of the United States.

When I was in China in January, there was an interesting article in the paper about the beginning of China importing foreign automobiles because the tariffs on those were going down by almost 75 percent. And the tariffs on manufacturing goods were down by the same amount. And that the Chinese rules on domestic content are going away with that accord. And that the foreign and national treatment of corporations has to be the same.

So China is really under the gun in complying with the WTO. They are painfully aware of the fact. When we were there, they talked about patience and everything. And I said, look-it, you wanted to get into this thing for 15 years. I'm going to be the first one to tell you there is no squeeze room. If you do not comply, there will be sanctions filed against you. And China is in the process now of they have to open up to more markets.

And, lastly, whenever the United States exports services, the merchandise factor follows. It is always that way. For example, the exporting of architectural services such as we do, such as what happens with Trade Development Agency. Whenever we design overseas systems, they are conveniently designed to accommodate American manufacturers. So that is why there is a lot of emphasis now.

We had an interesting discussion with Chen S'ing-he, who is the 38-year-old Vice President of the Shanghai Stock Exchange. Now Americans will be allowed to buy what are called Class A Chinese stocks as the Chinese state-owned enterprises become privatized. And I said how does somebody age 38 become the vice president of the Shanghai Stock Exchange?

He said, well, the president is a year younger than me. He said, Congressman, he said, anybody in China over the age of 40 does not understand how the stock market works. And I thought that was an astounding statement to see what is going on there in terms of that type of investment.

One of the reasons for this hearing or the reason is to make American manufacturers more competitive. I think it is extremely significant that even though Dr. Ferguson was not able to stay and listen to your testimony, he has all of your statements. And if you listened very closely to his testimony, which was nothing less than compelling, you will note that things that each of you said worked their way into his statement, where he addresses these various issues.

And now as a result of the letter that we sent, as a result of the work of the organizations that are represented here today, and as a result of your testimony about how sensitive machine tooling is to interest rates, the Fed, I can guarantee you, is going to be taking a different look at the manner in which they raise interest rates.

The opportunity for Dr. Ferguson to come to our district, and Don, I think you know of a good facility you would like to have him visit. We will make sure that he doesn't wear white shirts when he visits. I think the openness of Dr. Ferguson to travel the country, to listen to the people impacted, to me, that is the best indication of a public servant. He has a jurisprudence doctorate from Harvard——

Mr. BARTLETT. And a Ph.D. from Harvard.

Chairman MANZULLO [continuing]. And a Ph.D. from Harvard. This man is truly a public servant who has the interests of this country at heart.

And we will bring him out to our district as soon as possible because he needs to come up to speed as to what is going on in the area of machine tools.

Well, this has been nothing less than exemplary hearing. Lynn Martin, who is my predecessor and the former Secretary of Labor, furnished us with a 4-page statement that is going to be made part of the record. She would have been here today testifying with you were it not for the fact that she had a prior engagement.

Chairman MANZULLO. Did you have any concluding remarks you wanted to make, Mrs. Velázquez, and we will wind it up?

Ms. VELÁZQUEZ. No, just to thank all of you for being here today. This was an important hearing. And we will continue to work in a bipartisan way to help, you know, strengthen small business, especially small manufacturers.

Chairman MANZULLO. Thank you for your leadership.

Mr. Fedor, you wanted to say something?

Mr. FEDOR. Yes, sir. Well, I just had a couple of comments as you were making your remarks. One of the things that came to mind when we talk about China's increased willingness now to open their markets now that they are part of the WTO, as it regards companies like mine and small manufacturers, I think that the U.S. Government can be more of a friend to U.S. manufacturers in that regard if we continue to allow the machine tool market to open up regarding not putting unilateral controls on certain kinds of machine tools that we can export to China.

It seems to me that we are being maybe unintentionally hostile to small manufacturers like ours in putting unilateral controls on those kinds of products when really they can get that same technology from companies in France or somewhere in Europe quite easily.

I wanted to also make another comment. You had a comment, a question regarding the strong U.S. dollar and what you can do about that. I am not sure. I am not an expert in this area. It does not seem like you can necessarily legislate a change there but what we see is——

Chairman MANZULLO. Thank you, I appreciate that statement.

Mr. FEDOR [continuing]. Mr. O'Neil and the Treasury Department talking up the dollar and extolling the virtues of a strong dollar in itself almost creates a perception of a government policy toward a strong dollar. And I think that if we were to moderate the tone of the comments regarding the strong dollar perhaps that would have an effect. And also have the dollar float more with the strength of the U.S. economy. I am not sure how you do that, but with the strength of the economy have the dollar follow I think would be more appropriate.

Chairman MANZULLO. Congressman Bartlett, you had a concluding remark?

Mr. BARTLETT. I am on the Armed Services Committee and there we have a major concern with, obvious concern with exports to China. I guess that on that committee I am kind of politically incorrect because my position has been that we need a military industrial base in this country. We have a shrinking one. Part of that industrial base can be supported with foreign sales.

And my view has been that if the foreign country can buy the product or the service anywhere else in the world, we ought to be able to compete. It is good for our economy. Ultimately it will be essentially, I think, to our national security because we cannot depend on foreign countries to build our ships and build our airplanes and so forth.

The difficulty is deciding what in fact can be bought from any other place or from some other place in the world. But my general view is that if you can buy it anywhere else why can't our guys compete? And I noticed in your testimony you were concerned about limitations on exports to China. Nobody wants to export to a country technologies that will put them at a military disadvantage relative to us. But also I do not want to deny any export to them that will assist our manufacturing base. And, we are not now doing a very good job of reaching that balance. And, I appreciate your interest and your concern.

Chairman MANZULLO. Thank you very much. This Committee is adjourned.

[Whereupon, at 12:15 p.m., the Committee was adjourned.]

DONALD A. MANZULLO, ILLINOIS
CHAIRMAN

NYDIA M. VELÁZQUEZ, NEW YORK

Congress of the United States
House of Representatives
107th Congress
Committee on Small Business
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Why Add an Interest Rate Hike on our Struggling Small Manufacturers?

Hearing Before The United States
House of Representatives Committee on Small Business
2360 Rayburn Building; April 24, 2002, 10:00 a.m.

Opening Remarks of Chairman Manzullo

Good Morning and welcome to this hearing of the Committee on Small Business. I especially welcome those who have come some distance to participate.

A little over a month ago, I sent a letter to Federal Reserve Board Chairman Alan Greenspan, encouraging him to resist interest rate hikes in the near future. I explained that an important sector of our economy, namely small manufacturers, were still in recession. I further encouraged him to look at the state of the machine tool industry as a key indicator of America's economic health.

It now appears — I am pleased to observe — that the Federal Reserve will *not* raise interest rates at its next meeting on May 7.

The U.S. recovery is tenuous and does not have a firm foothold throughout all sectors of the economy. In this environment, an interest rate hike could devastate small manufacturers and impede the recovery. Before interest rates are raised, it is critically important that the state of this manufacturing sector be considered.

Manufacturing-based congressional district like mine hold clues for our national economy. Consider just two prominent news reports. In an article entitled "Some Manufacturers Find Recovery Elusive," the Chicago Tribune just reported that favorable government statistics haven't pulled many Illinois-based manufacturers out of the hole. The article -- from this past Sunday's edition -- stresses that "interest rates need to stay low."

The Washington Post calls Rockford, Illinois -- in the center of my congressional district -- "a barometer in the heartland." That was the headline of a three-page story in the Post's March 25, 2001 edition. The sub-headline says Rockford holds "clues to shifts in the U.S. economic climate." The article notes the influence that Rockford's situation should have with Federal Reserve policymakers. Rockford was a national predictor in the early 1980s, when its unemployment led the nation at a whopping 25 percent. It remains a predictor today.

Rockford is home to the heaviest per capita concentration of machine tool and die companies in the nation. Historically, machine tool companies -- also known as precision manufacturing companies -- are the first to slow down in a recession and the last to recover. Why? The answer is not that complex.

Machine tools are large capital investments. Before companies will buy this equipment, they must have confidence in the future of the economy and their ability to make the large capital investment pay off. After a major re-tooling of U.S. industry in the 1990's, many companies reached a saturation point or plateau. By 1999, they essentially stopped buying new machine tools, which should have been a key indicator that the U.S. economy was heading for a slow-down.

In other words, companies generally won't buy machine tools unless they are confident they will be around for another 5-10 years. If these companies do not have confidence in the future, they do not buy machine tools. It's that simple.

Thus, the key indicator on whether the economy is rebounding is *not* in inventories or manufacturing output. The key indicator is whether a company buys a machine tool to upgrade or modernize its production processes.

I'm here to tell you that Rockford's machine tool industry is struggling mightily, and is still a long way from recovery. These companies are rapidly losing market share and many are going out of business. As a result, the unemployment rates in Northern Illinois are several points higher than the national average.

All of the following factors are contributing to tough times for these small manufacturers:

- (1) Stiff foreign competition allows for very thin margins;

- (2) New steel tariffs will increase the cost of American production;
- (3) Overvalued U.S. dollar makes American manufacturers less competitive;
- (4) Tighter credit standards prevent small manufacturers from securing needed loans;
- (5) U.S. export controls and unilateral sanctions limit the ability of American companies to compete internationally;
- (6) Increased productivity leaves many businesses overstaffed and facing job cuts;
- (7) The heavy U.S. tax burden places American companies at a competitive disadvantage; and
- (8) Government regulations continue to overburden struggling American businesses.

While the country as a whole may be seeing its first glimpses of recovery, the small manufacturing sector, and especially the precision manufacturing sector, is not out of the woods. The predictive value of this sector should be heeded.

I applaud the Federal Reserve's apparent decision to avoid an interest rate increase until the economy has entered a period of sustained growth.

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

COMMITTEE ON SMALL BUSINESS
RANKING DEMOCRATIC MEMBER

COMMITTEE ON BANKING AND FINANCIAL SERVICES
SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES, AND GOVERNMENT SPONSORED ENTERPRISES

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STATEMENT
by the
Honorable Nydia M. Velázquez
House Small Business Committee
Fed Rate Hike Effects on Small Manufacturers
April 24, 2002

When Americans think of small business, the first image that leaps to mind is the small manufacturer --- the entrepreneur taking raw materials and producing real, innovative products. Small manufacturers still form the bedrock of our economy, and they deserve our support.

Today we are examining the effects that a potential interest rate hike by the Federal Reserve would have on more than 35,000 small manufacturers in this country.

I think everyone here agrees that now is not the time for a Fed rate hike. The economy is not growing fast enough to worry about inflation. I am pleased to learn that Chairman Greenspan shares this assessment.

Given that reality, I believe that in addition to examining the impact of a Fed hike, it is important to assess the long-term and substantial barriers that small manufacturers face.

By focusing on these challenges today and implementing a strategy toward overcoming these challenges, I am sure we can do far more to help small manufacturers than the Fed can do to harm them.

Small manufacturers, even in an economic downturn, are having a difficult time hiring skilled workers to get the job done. A long time has passed since Henry Ford reduced manufacturing to an assembly-line process that could employ practically anyone regardless of skill or education.

Today, manufacturers require a highly trained technical workforce. Because the skill barrier is so high, often these manufacturers are reduced to paying for worker training themselves, only to have them leave for bigger companies and better benefits.

We want to make it easier for small companies to pay for worker training --- and to hold on to those employees they train.

In addition, we know that technical assistance can double the success rate of small manufacturers. Programs such as the Manufacturing Extension Partnership can bring small manufacturers together with mentors and experts to increase productivity and profitability. Unfortunately, MEP is another in a long list of vital small business technical assistance initiatives facing cuts under the President's budget proposal.

Another major concern to small manufacturers is access to capital. Small manufacturers aren't just worried about the cost of capital --- they are also worried about the supply. When small manufacturers can't get capital, they can't buy new equipment. Without new equipment, their productivity falls and so does their competitiveness.

One obstacle blocking the path to increased capital supply is the 7(a) Loan Program. The recent budget proposal will cut this program in half, ripping an additional $5 billion dollars in capital out of the economy --- capital that could be financing new equipment and productivity. Instead, it sits in a ledger somewhere at the Treasury --- in effect, a subsidy of the federal government by this country's small businesses.

I look forward to the opportunity today to examine the Fed's impact in addition to highlighting other issues and challenges facing them. We are beginning the process of examining the challenges facing small manufacturers, which are the lifeblood of many communities across the country. I hope we can learn more about what we can do to help them thrive.

Small Business Committee Statement of Rep. Millender-McDonald Wednesday, April 24, 2002

Mr. Chairman. I am pleased to participate in today's hearing. Although the hearing focus explores the potential impact of an interest rate hike on small manufacturers, I think we need to delve a little deeper.

Clearly, an interest rate hike by the FED is likely to stunt investment

and development by small manufacturers. However, I think we should be exploring how desperately these companies need mechanisms that will deliver technical assistance to them. An excellent example of just such a mechanism is the Manufacturing Extension Program (MEP), which provides small companies with the managerial and technical assistance they require.

Furthermore, small manufacturers also need the benefit of a skilled and trained workforce, if in fact they plan on being competitive in the future. Therefore, I hope we can focus on these issues in order to assist small manufacturing firms to overcome the challenges that confront them.

I look forward to today's testimony and hope to gain additional insight about how our committee's efforts

can be of assistance to small manufacturing firms. Thank you.

Congressman Felix J. Grucci, Jr.
Small Business Committee
Hearing on the Effects of an Interest Rate Hike on Small Manufacturers
April 24, 2002

Thank you Mr. Chairman.

I would like to thank you for holding this hearing today on the effect of the interest rate hike on the small business community's manufacturing sector.

Today, manufacturing businesses make up close to 10% of all small businesses nation-wide. They are great contributors to the economy, trade and the production of goods across the country. During the past year – a year of economic slowdown – small businesses, across the board, faced some unexpected difficulties. The manufacturing sector was not immune to this trend.

In a year plagued with tragedy and economic hardships, the manufacturing industry had a sharp drop in profits. Skilled laborers throughout America did not have work, could not pay bills, and, in some occasions, were forced to shut their doors.

As a former small businessman, I understand the traditional hardships of owning a small business: paying rent on your building, finding healthcare plans for your employees, paying salaries, recruiting good employees and trying to compete with an increasingly global market. Life is not always easy for the small business owner. However, for those small-manufacturing businesses that were able to make it through last year, life is even more difficult.

I believe that we should be concentrating on how this Committee can work with the manufacturing small businesses to help them succeed. After a year of strain on an industry that is always battling overseas competition, should we be imposing more stumbling blocks in their way?

As we look into the issue of an interest rate hike, we, too, must consider the issue of lending. While it seems that lending slightly decreased over the last year, we must ensure that these small businesses have access to the capital necessary to overcome difficult times and compete in the global market.

I look forward to hearing your testimony and beginning a continuing a dialogue on how these small businesses would be affected by an interest rate hike. Thank you for being here.

For release on delivery
10:00 a.m. EDT
April 24, 2002

Statement of

Roger W. Ferguson, Jr.

Vice Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Small Business

U. S. House of Representatives

April 24, 2002

I am pleased to appear before your committee this morning to update you on recent economic developments and on the availability of credit to small businesses. In doing so, I want to emphasize that I speak for myself and not necessarily for the Federal Reserve.

Recent Economic Developments

When I met with your committee almost one year ago, overall economic activity had slowed noticeably after several years of rapid expansion. The economic boom that preceded the slowdown had been marked by an exceptionally high rate of investment in high-technology equipment and software and by a brisk pace of household spending. Some moderation in aggregate demand had seemed desirable if the economy was to return to a more balanced growth path. However, the declines in household spending for durable goods and in business outlays for new equipment in the fourth quarter of 2000 turned out to be more abrupt than many businesses had anticipated. As a result, many found that their inventories had become uncomfortably high. Manufacturers moved rapidly to adjust output in response to the disappointing final sales and to the efforts by businesses throughout the production and distribution system to reduce unwanted stocks. Indeed, the inventory correction was quicker than that in earlier business cycles.

What looked at the outset to be a gradual cooling of an overheated economy became much more serious—particularly in the manufacturing sector—for several reasons. First, the shakeout in the high-tech sector proved to be not simply an adjustment to slower domestic demand but a more fundamental reassessment by businesses, globally, of the profitability of additional fixed capital added to the already high stock of such capital. Besides the plunge in demand for high-tech products, our exports were hit hard by the slowdown in economic growth abroad. Lastly, the shock to confidence and spending in the wake of the tragic events of September 11 extended the weakness in the economy that had emerged over the first half of the year.

As the economic slowdown unfolded during 2001, the Federal Open Market Committee moved aggressively to counter the weakening in economic activity and to limit the extent of the downturn. In the event, I believe that monetary policy substantially cushioned the negative forces weighing on the economy. Homebuilding was visibly buoyed by lower mortgage rates. Because of more attractive mortgage rates, consumers were able to reduce payments, extract some home equity, and pay down more expensive forms of credit. At the same time, automakers drew a record number of new car buyers into showrooms by offering generous financing deals. Indeed, in contrast to earlier economic contractions, consumer spending held up remarkably well last year. The favorable effects of lower interest rates on borrowing costs and the boost to disposable income from the federal tax cuts and falling energy prices largely offset the deterioration in consumer confidence, the decline in wealth from lower equity values, and the rise in unemployment.

Compared with the previous four downturns that we had experienced since 1969, last year's downturn appears to have been mild overall. However, it differed importantly in its composition. Between the first and fourth quarters of last year, real disposable personal income, real personal consumption expenditures, and real outlays for residential construction increased more rapidly than in the preceding four economic downturns. In contrast, because of the particularly sharp retrenchment in capital spending for high-tech equipment, firms cut back their capital spending more extensively than was typical of earlier business cycles. The inventory correction was, as I noted earlier, much more prompt, and as the cycle played out, it became a more substantial drag on domestic production than had been the case in earlier downturns.

Because the cutbacks in demand centered on goods, the manufacturing sector was hit particularly hard. Indeed, the contraction in manufacturing production began in the second half of 2000—well before the cyclical peak in March of 2001—when the inventory correction and retrenchment in capital spending developed. And, though the recession in real GDP was mild by historical standards, the cumulative drop of more than 7-1/2 percent in manufacturing industrial production from June 2000 through December 2001 was larger than the decline in any of the previous four recessions. As a result, capacity utilization in manufacturing dropped over that period to 73.1 percent in the fourth quarter of last year—7-3/4 percentage points below its longer-run average.

Although the weakness in the manufacturing sector from mid-2000 through the end of last year was widespread, the global plunge in high-tech investment stands out as a significant drag. After having climbed at a rate of more than 35 percent per year in 1999 and 2000, our output of high-tech products—computers, communications equipment, and semiconductors—contracted at an annual rate of 21-1/2 percent between December 2000 and September 2001; capacity utilization in this group of industries fell from 81 percent to just under 61 percent in the fourth quarter of last year. Other non-high-tech industries, such as apparel, industrial and electrical machinery, and instruments, were also relatively severely affected by the declines in domestic spending and steep drops in exports in 2001.

On a more positive note, two other distinctive aspects of last year's recession are important for the longer-run outlook. The economy entered the recent slowdown, first, with a much lower rate of inflation and, second, with a noticeably higher rate of increase in productivity than during the other recession episodes since the mid-1970s. In both cases, the favorable performance has been well maintained into the first part of this year and provides a solid basis for a return to sustained noninflationary economic expansion.

As Chairman Greenspan reported in his testimony before the Joint Economic Committee last week, prospects for a renewed expansion have now brightened significantly. The economy appears to have been expanding at a significant pace in recent months. Household spending is holding up well, business spending on new equipment appears to have firmed, and preliminary data suggest that inventories are being drawn down less rapidly than at the end of last year. Of course, I should caution that, at this early stage, the degree of strengthening of final demand—a key factor in shaping the contour of the upturn—is still uncertain.

That said, our estimates of industrial production, which were released last week, indicate that manufacturers have begun to benefit from the pickup in the economy to date. Overall IP began to increase again in January, and indexes for almost 60 percent of the individual series for which we calculate production were by February above their levels three months earlier. We estimated another broad-based gain of 3/4 percent in IP for March. Production in several of the high-tech industries in which demand and output had plunged last year—office and computing equipment and semiconductors—had begun to firm toward the end of last year and then posted strong gains in the first quarter. Last quarter also saw some reversal of the steep declines posted in 2001 in industries producing various consumer goods and in those producing construction supplies and industrial materials. In other instances, such as industries producing non-high-tech business equipment, first-quarter performance was more uneven.

Of course, the cyclical recovery in the manufacturing sector will be superimposed on the longer-run structural trends in domestic goods production. Our manufacturers have over time been a strong and steady source of advances in productivity, and thus, the sector continues to be a significant contributor to the nation's overall economic growth. At the same time, because advances in manufacturing have required increasingly less of our economic resources, they have implied a noticeable secular decline in the share of jobs in the manufacturing sector. Furthermore, the increased globalization of goods production and the competitive pressures that have ensued have had additional consequences for the extent to which worldwide demand for goods has been met by U.S. firms and their workers—and those consequences have varied by industry.

The Survey of Small Business Finances

Turning to issues more directly related to small businesses, I want to begin by noting that the results from the Federal Reserve Board's Survey of Small Business Finance (SSBF) had just become available when I testified before your committee last May. At that time, I discussed with you, in broad terms, our findings regarding the use of credit and other financial characteristics of small businesses. As you may know, the survey results are one of the inputs into the report that the Federal Reserve sends to the Congress every five years detailing the extent of small business lending by all creditors. That report, which we prepare in consultation with a number of other agencies, will be completed later this year.

As we have discussed before, the Survey of Small Business Finances can be used to examine a range of issues, including the study of specific groups of firms. This morning, I would like to draw on the results of the survey to focus on what they tell us about small manufacturing firms.

According to our 1998 survey, about 8 percent of the more than 5 million nonfarm, nonfinancial small businesses—that is, those with fewer than 500 employees—were manufacturing firms. Those manufacturing firms were larger than other small businesses: Both average employment and average receipts at small manufacturing enterprises were about twice those at other small businesses. As a result, small manufacturing firms accounted for about 14 percent of small business employment and around 17 percent of small business receipts.

Despite considerable structural change and consolidation in the financial service sector and the increased accessibility to capital markets by small businesses, commercial banks continued to be the dominant provider of financial services to most non-tech small businesses in

1998. These patterns were similar for manufacturing and nonmanufacturing firms. About 55 percent of small businesses overall, and nearly 60 percent of small manufacturing firms, obtained credit from market sources or institutions. As is the case with other small firms, more than 70 percent of small manufacturing businesses with a credit arrangement—such as a line of credit, a loan, or a lease—had a relationship with a commercial bank.

Recent Trends in Small Business Financing

No doubt, the economic and financial environment has become less conducive to risk-taking and leverage since the survey was conducted in 1998. The economic slowdown of the past year led to a deterioration of corporate profits and an escalation of bond defaults and loan delinquencies. As profits fell and businesses revised down their expectations for sales and their expansion plans, investors became less certain about the returns they should expect on investments. The dramatic rise in problem credits and the rapid pace at which we saw firms fall from stellar ratings to bankruptcy also led investors to reevaluate their views about the financial well-being of businesses and their creditors.

Thus far, we have seen few signs of the types of financial headwinds that, in the early 1990s, had played havoc with the ability of many creditworthy small firms to roll over loans and renew credit lines. Credit flows to businesses have fallen much more modestly in the recent cycle, even as firms slashed their investment in fixed capital and inventories. Moreover, financial institutions have maintained their capital and liquidity as delinquency rates of business and real estate loans did not reach the highs witnessed in the earlier period.

As the Federal Reserve aggressively cut the federal funds rate in 2001, borrowing rates for most businesses dropped sharply despite persistently high risk spreads for lower-rated firms. Low interest rates prompted investment-grade nonfinancial corporations to issue a record volume of bonds, and issuance continues to be strong this year. These firms used the proceeds to strengthen their balance sheets by repaying short-term debt, refinancing other long-term debt, and building up liquid assets. Though investors appeared cautious, non-investment-grade companies were also able to raise funds: junk bond offerings have accounted for about one-quarter of total public debt issuance. At commercial banks, rates on business loans declined, but loans at large banks fell sharply. In contrast, loans at small banks, which make many loans to small businesses, expanded moderately last year and have continued to do so this year.

As you are aware, the Federal Reserve regularly surveys senior lending officers around the country—principally at large banks, but also at a selection of small banks. The survey, which is administered quarterly, asks banks about their credit terms and standards, loan demand, and other issues that may be topical. During the market turmoil in late 1998, banks began looking harder at the loans they made to large and middle-market businesses. In each quarter over the past three years, more banks reported having firmed their lending standards than reported having eased their lending standards for large and medium-sized borrowers. Not surprisingly, banks have been particularly vigilant during the recent economic downturn, with 40 to 60 percent, on net, having tightened their lending standards. Of particular relevance to this committee is the fact that the net portion of banks that reported having tightened their lending standards for small borrowers was about 10 percentage points below the net portion that reported having tightened standards for larger borrowers.

The senior loan officer survey also questions banks about why they tightened their lending standards. In 2001, banks commonly cited uncertainty about the economic environment, worsening industry-specific problems, and a reduced tolerance for risk. The survey further questions banks about their perception of borrower demand. In the most recent survey, about one-half of the banks surveyed reported that the demand for business credit continued to decline—a high fraction by historical standards, but lower than the roughly three-fourths that reported declining demand in the fourth quarter of last year. Banks attributed declines in loan demand to reductions in planned investments and diminished financing for mergers. This view held by bankers is confirmed by surveys of small businesses. According to surveys conducted by the National Federation of Independent Business (NFIB) in 2001, only about 12 percent of respondents, on average, thought that it was a good time to expand, roughly half the percentage of a year earlier. Few firms reported financing costs as a reason for believing that expansions were not a good idea.

Indeed, since the beginning of 2001, NFIB respondents have not viewed financing conditions as onerous. The percentage reporting that they found credit more difficult to obtain has remained moderate and well below the highs witnessed in previous economic downturns. In addition, for creditworthy small businesses, interest rates on bank loans have declined with the easing in monetary policy. The average short-term interest rate paid by NFIB respondents decreased about 3 percentage points, to its lowest level in more than two decades.

Though we may take comfort from the lack of angst expressed by small borrowers in the NFIB surveys as well as from the lower loan interest rates, we must recognize that, given the tighter lending standards, some small businesses have almost certainly found credit difficult and more expensive to obtain. Small manufacturing firms, in particular, may have faced tight credit constraints, as their profitability fell sharply last year and their business prospects became more clouded. Indeed, such constraints are suggested by a recent survey conducted by the National Association of Manufacturers (NAM), an association whose membership is heavily weighted toward small and middle-market manufacturing firms. The survey found that 2 percent of respondents thought it was "impossible" to get credit, a further 16 percent reported that it was "much more difficult" to do so, and another 16 percent reported that it was "slightly more difficult" to do so. Of those experiencing difficulty in obtaining credit, 19 percent cited tougher credit standards as the explanation. But nearly 40 percent of the respondents cited a decline in profits and a slowing economy as the explanation for experiencing difficulty in obtaining credit.

However, I note that recent data from the Quarterly Financial Reports of Manufacturing, Mining, and Trade Firms (QFR) show that outstanding bank loans to manufacturers with less than $25 million in total assets actually increased moderately in 2001. In contrast, bank loans to larger manufacturing firms were falling.

Bank Supervision

Turning from the aggregate measures of credit availability to the role of the Federal Reserve as a bank and a bank holding company supervisor, I want to emphasize that the current credit conditions that individual businesses now face reflect the judgments of individual lenders about the underlying credit risks of their customers and about their own financial strength and appetite for risk. In our supervision of bank holding companies and state-chartered member banks, the Federal Reserve's overall goal is to promote prudential lending and risk-management practices by these institutions. In conducting our activities, we recognize that credit decisions must be left to banks; our examiners do not advise whether particular loans should or should not be made. Our role is to evaluate an institution's policies, practices, and controls to ensure that they are sound and that they are administered impartially, according to law. Of course, we must be mindful of the possibility that excessive reactions by banks or their regulators to emerging weakness could deprive creditworthy borrowers of financing and curtail economic growth, and we seek, at all times, to maintain a proper balance in our supervisory approach.

Supervisors need to evaluate the results of a bank's lending activities and will act to address the deterioration if or as problems build. As you recall, they did so most visibly, for example, in the early 1990s. Supervisors also need to anticipate potential problems and, to that end, occasionally issue cautionary guidance to banks when the Federal Reserve perceives that their lending standards are weakening and that they are not fully considering the likelihood of adverse events. Cautionary guidance was issued to banks in 1995, spurred by mounting evidence received from examiners, industry surveys, and other sources that the industry's lending standards had declined. Similar guidance was repeated in 1998, following a more focused and intensive review of bank lending practices by our supervisory staff, and again in 1999, following an interagency review of large syndicated loans. Even so, none of these statements directed or encouraged banks to constrain lending but rather urged them to recognize risks in both current and less favorable economic conditions and to exercise balanced judgment at all times.

In contrast, the Federal Reserve has not issued any such statements during the past two years. However, we do provide the industry each year with statistics regarding the volume of credits criticized by examiners as part of annual interagency reviews of large syndicated loans. In recent years, those statements have highlighted the continuing decline in bank asset quality. Though such announcements may sensitize banks and bank supervisors to risks in the current environment, they contain information that we believe all parties should have and should consider when evaluating exposures and loan requests.

Summary

Obviously, 2001 was a rough year for the economy, and given the nature of the downturn, it was particularly rough for the manufacturing sector. Credit flows did slow, driven largely by the falloff in the demand for funds as the economy softened and the reduced pace of merger and acquisition activity. Overall, the tightening in credit standards that occurred was principally a response to the weak economy and declining profits, and thus it reflected a prudent pulling back of lending.

The outlook, however, has brightened: Industrial output has begun to turn up, and various surveys of business conditions suggest that orders are increasing. These developments are encouraging signs, but they are no guarantee that a sustained solid expansion of final demand has gained traction, and we will be monitoring economic developments closely in coming months. Accordingly, the assessment of the Federal Open Market Committee at its most recent meeting was that the risks to the outlook in the near term were balanced between economic weakness and pressures on inflation. The committee kept the federal funds rate at its current level of 1-3/4 percent, which implies that monetary policy remains accommodative. The FOMC's focus will remain on fostering a balanced, noninflationary economic recovery. As you know, monetary policy works with one instrument in a national money market. As a result, we cannot and should not set policy with an eye to the outcome in a particular sector of the economy. However, we believe that promoting our longer-run objectives of maximum sustainable economic growth and financial stability will produce an environment in which the broadest range of businesses and households will prosper.

U.S. EXPORTERS IN THE GLOBAL MARKETPLACE:

AN ANALYSIS OF THE STRENGTHS AND VULNERABILITIES OF

SMALL AND MEDIUM-SIZED MANUFACTURERS

Testimony of

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Before the

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House of Representatives

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U.S. Exporters in the Global Market Place:
An Analysis of the Strengths and Vulnerabilities of
Small and Medium-sized Manufacturers

Michael R. Czinkota

Chairman Manzullo, distinguished members of this Committee, it is a great honor for me to testify before you today. This invitation fits well with the research program at my institution. At Georgetown University's McDonough School of Business, where I teach, our international marketing team has systematically tracked the activities of international firms for more than two decades. One key focus that we have developed rests with small and mid-sized U.S. exporters. We analyze such firms and collect information from them on an ongoing basis in order to track their concerns and forecast changes in international business practices. Given the emphasis of these committee hearings on U.S. manufacturers I will provide you today with an overview of the role of exports in the economy and the key reasons for the international successes and failures by U.S. exporters of manufactured goods.

WHY EXPORTS ARE SPECIAL

Exporting is one of the many market expansion activities of the firm. As such, exporting is similar to looking for new customers in the next town, the next state, or on the other coast; it differs only in that national borders are crossed, and internationals accounts and currencies are involved. These differences make exports special from a policy perspective.

Exports are special because they can affect and are affected by currency values and the fiscal and monetary policies of governments, shape public perception of competitiveness, and determine the level of imports a country can afford. Abroad, exports augment the availability and choice of goods and services for individuals, and improve the standard of living and quality of life.

The United States is increasingly vulnerable in its international trade position. Since 1975, it has been importing more goods than it has been exporting, therefore running a continuous merchandise trade deficit. Even though overall U.S. exports were above $ 1 trillion in 2001, the deficit in the trade of goods was more than $ 426 billion. Ongoing annual trade deficits of this magnitude are unsustainable in the long run. Such deficits add to the U.S. international debt, which must be serviced through interest payments and eventually perhaps even repaid. Therefore, an export performance by U.S. firms, which matches or even exceeds our imports, will increasingly be crucial for the nation. Furthermore, exports are also an important contributor to national employment. We estimate that $ 1 billion of exports supports the creation, on average, of about 11,500 jobs. In its latest benchmark study, the U.S. Department of Commerce reports that there were over 8 million U.S. jobs sustained by the export of manufactured goods, which ties one out of every five U.S. manufacturing jobs directly or indirectly to exports. For example, in the state of Illinois alone, more than 360,000 jobs were linked to manufactured exports. An increase in exports can therefore be a key factor in maintaining domestic job growth.

On the level of the firm, exports offer the opportunity for economies of scale. By broadening its market reach and serving customers abroad, a firm can produce more and do so more efficiently, which is particularly important if domestic sales are below break-even levels. As a result, the firm may achieve lower costs and higher profits both at home and abroad. Through exporting the firm benefits from market diversification, taking advantage of different growth rates in different markets, and gaining stability by not being overly dependent on any particular market. Exporting also allows a firm to learn from competition, makes it sensitive to different demand structures and cultural dimensions, and proves its ability to survive in a less familiar environment. All these lessons can make the firm a stronger competitor at home. Since exporting is only one possible international marketing strategy, it may well lead eventually to additional activities such as direct investment abroad, joint ventures, franchising or licensing. Finally, one should keep in mind that over the past few decades, the volume of international transactions has consistently grown substantially faster than that of domestic economies. As a result, when exporting firms go global, they are following the Willie Sutton principle by going "where the money is."

Overall, corporate exports contribute to the growth and economic strength of the firm, and, on an aggregate level, to the economic security of the nation.

THE STRENGTHS OF SMALL AND MID-SIZED EXPORTERS

Many see the global market as the exclusive realm of large, multinational corporations. Overlooked is the fact that hundreds of thousands of smaller sized firms have been fueling a U.S. export boom, which has supported the economy in times of limited domestic growth. The latest information from the trade data project at the Department of Commerce indicates that between 1987 and 1999, the number of U.S. firms that export at least occasionally more than tripled to over 231,000. Almost 97 percent of these exporters were small or mid-sized companies.

The reason for the export success of smaller firms lies in the new determinants of competitiveness, as framed by the wishes and needs of the foreign buyers. Other than in the distant past, where price alone was at the forefront, buyers today also expect an excellent product fit, high levels of corporate responsiveness, a substantial service orientation, and high corporate commitment. Small and mid-sized firms stack up well on all these dimensions compared to their larger brethren, and may even have a competitive advantage.

Take the issue of product fit. In today's era of niche marketing, where specialization rather than mass production is prized, the customization of operations is often crucial. In a large corporate system one often hears that adjustments cannot be made since the current approach is a matter of "policy". As a result, changes in production processes are often subject to delays as various layers of management are consulted, costs recalculated, and multiple communication levels exercised. In a smaller operation, procedures can more easily be adopted to the special needs of the customer or to local requirements. Particularly because they are often not able to compete on price, small and medium sized firms are increasingly the specialists of the global marketplace.

Smaller firms can offer clearer lines of accountability since the decision maker can be more visible and responsive to the customer. During negotiations, or later on, if something does not go according to plan, the customer knows whom to contact to fix the problem. Smaller firms are better equipped to handle exceptions. Since international sales situations have high variability, either in terms of the timing or the nature of the sale, a smaller firm can provide a more flexible framework for the decision process. Exceptions can be handled when they occur rather than having to wait for concurrence from other levels of the organization.

Smaller firms can offer their customers better inward and outward communication linkages. They can quickly form a network with direct ties between the original provider of a component, service or product, its distributor and its end user. The result is better contact and a short response time from supplier to customer. If a special situation should arise, response can be immediate, direct, and predictable to the customer, providing precisely those competitive ingredients that reduce risk and costs.

There are also greater gains from the experience curve effects of exporting by smaller firms. Research by the Boston Consulting Group shows that each time cumulative output of a firm doubles, the costs on value added decrease between 20 to 30 percent. Due to the smaller customer base, it is much easier for a small or mid-sized business to double cumulative output and reap the resulting benefits than it is for a large established firm. Most importantly, once a small firm goes international, it usually does so with the full commitment of the owner and top management. The foreign customer therefore knows that this export activity has management's heart and soul behind it. Given today's business trend away from transactions and toward the building of relationships, such a perception may be crucial in providing the winning edge.

SOME KEY VULNERABILITIES OF SMALL AND MIDSIZED EXPORTERS

In spite of all these advantages, firms also face major obstacles to international market prosperity which make them vulnerable. Firms tend to internationalize in stages – starting out from a position of complete unawareness of international opportunities. Typically, they progress gradually by becoming aware, interested, experimental and, finally, fully fledged exporters. Their concerns change as they progress through these stages. Yet, overall, smaller firms tend to encounter four types of export-related problem areas. These are financial issues, supply chain management, regulatory issues and market contact.

1. Financial Issues

All firms worry about getting paid when they ship their merchandise abroad – but small and mid-sized exporters are particularly vulnerable. The international transaction needs financing to cover the time lag between shipping and payment receipts as well as to offer credit to buyers. Longer distances, slower transportation, and more accommodating payment terms abroad make international transactions more expensive. They require more capital and represent a larger portion of the firm's resources than do domestic transactions.

Exchange rate changes present a major source of vulnerability. As time passes between the initiation of an international transaction and its consummation, the exposure of the firm to currency shifts grows. Rapid major changes of currency value can transform a good business transaction into a money losing one.

One particular issue U.S. exporters must cope with the relatively low value of the Euro – the new key international trade currency that the European Union implemented widely on January 1 of this year. Even though originally introduced at a value slightly higher than the dollar, the Euro is valued now at only 88 cents. In consequence, U.S. imports from Europe are now cheaper, but U.S. exporters find it much more difficult to compete.

Smaller firms also do not have the unfettered access to global capital markets that large firms have. They are the ones who still rely very heavily on only domestic or even local sources of money. As a result, they do not benefit from the low cost sources of global capital and are not diversified enough in their sources of funds to be able to cope with local interest rate inefficiencies. Given the increasing commoditization of goods – where price is a decisive criterion in getting the order, shifts in price due to interest or exchange rate changes may critically affect the competitiveness of the firm.

2. Supply Chain Management

Key concerns here are the development of contacts, relationships and networks with suppliers and the forging of a systems linkage with intermediaries and customers. In addition, there are the logistics of arranging transportation, determining transport rates, handling documentation, obtaining financial information, coordinating distribution, packaging, and obtaining insurance. This area also includes the servicing of exports, where the firm needs to provide parts availability, repair service and technical advice and often has to open a servicing or distribution office abroad.

Timely communication among the different members of the supply chain is crucial if a firm is to perform competitively. Here again, small and mid-sized firms are particularly vulnerable, since they need to invest heavily in information technology – a major capital outlay. Since they do not have the clout of the large firms which can require even their international supply chain members to adapt to a standardized information system, smaller firms often have to adapt to multiple systems and find ways to make them internationally compatible – thus incurring additional expenses and technical difficulties.

Firms that have developed elaborate just-in-time delivery system for their international shipments were also severely affected by the border and port closures during the days following the terrorist attacks on the United States. Together with their service providers, they are still affected today by the increased security measures. Firms now need to focus much more on internal security, and they need to demonstrate to the outside how much more security oriented they have become. In many instances, government authorities require evidence of threat reduction efforts to speed things along. Also, insurance companies have increased their premiums substantially for firms exposed to increased risk.

3. Regulatory Issues

Another key vulnerability consists of legal procedures and typically covers government red tape, product liability, licensing, and customs/duty issues. Here, small and mid-sized firms are particularly exposed to changing government policies. The terrorist attacks of September 11th have profoundly affected the administration of U.S. export controls and customs procedures. While larger firms may have the benefit of a fully staffed department that deals with regulatory affairs, smaller exporters often face new and unfamiliar territory, which is very expensive to conquer in safety. They need to scrutinize export control regulations much more closely. In addition, customs classifications and rules may require the hiring of specialists who ensure that shipments go out in time.

On the regulatory side, our firms are also exposed to the vicissitudes of trade policy. Market access and market performance issues will, hopefully, be taken up in the upcoming Doha Round of trade negotiations. However, in existing trade disputes, our firms are also threatened by the retaliatory measures taken by trade adversaries. Even though the conflict may be totally unrelated to their industry, U.S. manufacturers are vulnerable to foreign trade policy actions that are specifically designed to elicit the largest amount of pain from their victims.

4. Market Contact

Firms need to cope with advertising, sales effort, and the obtaining of marketing information. They also need to develop foreign market intelligence, which covers information on the location of markets, trade restrictions, and competitive conditions overseas. For large firms, such activities are often part of market expansion, where additional activities are carried out in already familiar territory. Small and mid-sized firms, however, are still at the level of international market entry, where each step requires the dedication of new resources to unfamiliar tasks. It bears remembering that any new entrant into the international market must not only match, but must exceed by far the capabilities of the local competition in order to be successful. After all, apart from needing to find the spare capacity among its management resources, which permits a corporate focus on and commitment to exports, the newcomer has to carry all the transaction costs associated with the internationalization process. These start with the cost of shipping, special packaging and include duties and other special international burdens. It is after the absorption of all these costs of going global that the exporter begins to compete in an unfamiliar field with opponents who are on their home turf.

All these obstacles, both real and perceived, often prevent firms from exporting. Many managers often see only the risks involved in exporting rather than the opportunities that the international market can present. As a result, the United States still under-exports when compared to other nations. U.S. merchandise exports comprise only 11 percent GDP, compared to 28.3 percent for Germany and 25.4 percent for the United Kingdom. On a per capita basis, the United Kingdom exported in 2000 $6,226 for every man, woman and child. The figure for Germany is $7,498; for the United States, it is only $3,878.

SOME OPPORTUNITIES FOR SUPPORT

Small and mid-sized U.S. firms have greatly increased their participation in the global economy. Nonetheless, still today, only a very small portion of these firms exports. Of those that do so, 63 percent export to only one country. It would be good for the firms and the nation if the number of smaller sized exporters and the number of markets served by them could be dramatically increased.

At this time, U.S. export performance is insufficient given its potential. Many of our small and medium-sized exporters are too complacent to globalize since they are content with a vast domestic market. Those firms that do consider global opportunities appear to be unwilling to initiate major expansions of their operations abroad because of their real and perceived risk and vulnerability in the international market.

One core business concern is financing. On the positive side, private lenders of trade finance are becoming increasingly more active in the United States, but they often lend at relatively high rates. U.S. exporters do have the benefit of well working government programs such as the working capital guarantee program by the Export Import Bank of the United States (Eximbank), which provide for assistance in financing. Several programs are specifically designed to help small business exporters, but there is still a cultural bias in favor of the larger sized transaction by the larger sized firm. There needs to be a continuous emphasis on small business lending support and a responsible adaptation of credit criteria for the conditions of small and medium sized enterprises. Often small and mid-sized firms cannot afford to provide all the detailed evaluations and documentations that lenders ideally would like to see.

Of key relevance is a stable financial environment, both domestically and internationally. Small and mid-sized firms have already demonstrated that they can cope with changing conditions. However, we know that the speed of change can severely affect or even destroy the profitability of operations. Any policy measures that affect the access to and the cost of capital of smaller sized firms or the exchange rate of the dollar should specifically take into account the consequences and burden that such steps would impose on U.S. exporters.

In developing supply chain management capabilities, our firms are also often caught in a financial bind. Whenever investment in marketing, sales or distribution support operations abroad is required, financing for such activities is hard to find.
Theses activities do not fall under what lenders consider to be trading activities, nor do they constitute sufficient large collateral abroad to warrant lending from a foreign investment perspective. In addition, if a firm uses such investment to improve and streamline its supply chain, the resulting savings in inventory and supply chain processes may reduce the ability of the firm to borrow, since less inventory means that there will be less collateral for asset based loans.

On the regulatory side, a stable international trade environment is, in itself, an important support for smaller sized firms. Trade disputes, particularly between large regions or countries, may remind small and mid-sized exporters of the proverb "when elephants stomp, the grass gets crushed." They are the ones least able to circumvent trade sanctions or to quickly shift to new markets. A specific review focus on smaller firms would be helpful when it comes to government policies such as export administration regulations. Intensive outreach efforts should be designed in order to increase the awareness of such regulations as well to enhance the capabilities of firms to comply with them.

In order to help smaller sized firms to better understand foreign markets and their customers, more information is essential. The past few years have seen a substantial improvement in available information. For example, only six years ago, I would not have been able to provide the data details that are part of this testimony. Congress has helped substantially with its support of the Trade Data Enhancement Program at the Commerce Department that allows more in-depth analysis and better dissemination of Census data. More of these data driven insights are needed since we are dealing with a very dynamic environment. We must remember that in any given year 15 percent of U.S. exporters stop exporting, while 10 percent of non-exporters newly enter the global market. Collaboration between federal agencies and industry or professional organizations such as the American Marketing Association or the Council for Logistics Management would be useful for the development and dissemination of data. That way, we can improve our understanding of who the dropouts and the newcomers are, and broaden our analysis to include the many exporters of services about whom we have only limited data.

It would also be useful to have a globalization index of countries available. Such an index, work on which we are considering at Georgetown University, would not just focus on trade. It would also incorporate dimensions such as family, culture, freedom and the pursuit and exchange of knowledge in rating the extent to which nations have become global. Knowing about such a measure would greatly facilitate the market selection and market servicing decisions of firms.

Our small and medium-sized exporters are facing rapidly changing global realities. As the gruesome attacks of September 11th have shown us, risk and danger can emanate from unexpected quarters and can have a major effect on our activities. The likelihood of continued and closer global linkages and interdependence is high. To succeed internationally, our firms need to make a major commitment to international operations by devoting financial and managerial resources to the tasks. They need to be able to fight and win the battles of competition in the international marketplace. On the policy side, we need to ensure that our firms have a strong, healthy and competitive platform from which to launch their international ventures.

Chairman Manzullo, distinguished members of the Committee, thank you very much for your attention. I will be glad to answer any questions you might have.

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STATEMENT

BEFORE THE
U.S. HOUSE SMALL BUSINESS COMMITTEE

April 24, 2002

"WHY ADD AN INTEREST RATE HIKE ON OUR STRUGGLING SMALL MANUFACTURERS?"

BY
Mr. DON METZ
VICE PRESIDENT
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ROCKFORD, ILLINOIS

On behalf of the
NATIONAL TOOLING & MACHINING ASSOCIATION
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ISTMA

ISTMA AMERICAS

Good morning. Mr. Chairman, Members of the Committee, I thank you for the opportunity to testify on behalf of the 2,500 member companies of the National Tooling & Machining Association and the NTMA local chapter in Rockford Illinois, regarding the negative impacts raising the interest rates could have on the tooling and machining industry.

It was June of 1976, and I was introducing President Gerald Ford to the Greater Rockford Tool & Die Association. That night, the country was locked in deep recession. The men and women listening to the president were despondent, discouraged and a little fearful. President Ford stepped to the microphone and said, "I am absolutely convinced that this country, because of its people, because of its structure of government, because of the policies we pursue, will meet and conquer this challenge.

Fifty-five years ago, my parents, Jim and Betty Metz, left their family-owned farms on the Missouri-Arkansas line, to come to northern Illinois to seek their version of the American dream. Armed with a faith in God, a willingness to sacrifice and a true belief that hard work would pay dividends, they began on their journey.

After years of fair competition, dedicated workers, and loyal customers, the next 40 years brought growth and prosperity to Metz Tool & Die. Today we employ over 25 employees that make excellent wages. We engage in a wide range of precision machining, tooling, die and mold building and many other technical areas. We are artists that sculpt in steel, the visionary who makes your dreams become products. When you have an idea, it is the mold maker and his artistry that puts it in steel that produces something that can be sold. Everything that is mass-produced from the plastic rattle you shake as a baby, to the hardware that decorates your casket when you are laid to rest, comes from our industry. Our industry played a major role in our family life. Not in just in the business sense but in the life of my son, Matthew Metz.

Matthew lived only 16 years and he spent those 16 years in a wheelchair with the disease of Jerry Lewis' telethon, Duchenne's muscular dystrophy. Because of Matt's handicap, he had many special needs such as beds, lifts, and wheelchairs. We often turned to my dad, the mold maker, to make it bigger, stronger, and better and show us how to make Matt's life more comfortable. One day when I was agonizing over a bed that needed to be adapted for Matt's special needs, Matt said to me, "Don't worry about it Dad, Grandpa is a mold maker. They can make anything."

As the new millennium, came mold makers and die makers faced a new challenge. Lured by the promise of a cheaper workforce, fewer taxes, and few environmental or occupational regulations, many of the large manufacturing companies began closing their American based facilities and moving overseas.

Not only are foreign companies providing cheap labor, they are quickly closing the gap in the skill of the employees and technology. Foreign governments are providing strong financial incentives to their companies to purchase the latest technologies, as well as covering the cost of training the employees.

This is of particular concern to my employees and me. When a large company such as Motorola closes its shop in Rockford they take all of the jobs that would normally be contracted out to my shop with them. Thus, in order to survive I have to quickly replace those jobs lost overseas in a market that continues to grow smaller and smaller.

Today, as in 1976 when I introduced President Ford, our industry is depressed and very concerned about the future. Over the last two years I have had many opportunities to talk to my counterparts and walk through their shops and discuss their stories. As I walked down the halls with one shop owner I looked to my right and there was a $100,000.00 CNC machine sitting idle. Farther down the isle was a $300,000.00 machining center with no work on it. I saw benches that used to house the tools of skilled mold makers and die makers that were now empty because many of them had been laid off. Just because the company is not doing any work that does not mean the mortgage payments or the interest payments on those machines or the principle payments quit coming.

I was in another tool and die shop later, on a day that was called *"No Work Friday"*. So much work had gone off shore this man could only open his company 8 hours a day, four days a week instead of his usual 55. On this *"No Work Friday"* as I stood in his plant the silence was like that of a tomb. I saw other things that day. I saw medical rates that are increasing at double-digit rates, while at the same time benefits and health plan choices are decreasing. I saw worker's compensation costs that keep coming, I saw fire insurance that keeps increasing and they were like millstones hanging around his neck as we stood there in the silence. I also saw suppliers that don't get to sell there, I saw yard people that don't work there, uniform men that don't deliver there, rubbish people that don't collect there because when your business is off 40 - 50 - 60 percent you don't need any of that.

I talked to another company owner in his shop, Dial Machine and he told me that he began his shop as a young man, and over the years was successful. He built it up and told his two sons "you go to college and get your education, and when you come back, you take this business to the next level." His sons went to college and one even got a master's degree. But when they came back they told him, "There are no jobs for us here the business is gone." The father sadly told me his work life was almost over and he could go off into the sunset. But, he could see that he was not going to be leaving a business for his sons.

For those companies who are still in business we are faced with a shortage of skilled workers. According to Department of Labor estimates, the need for skilled labor in these trades is 2% annually of the current workforce. However, with the lack of "new blood" entering the industry, that percentage jumps to 5% when you take into account the average age of workers currently in the industry is better than 50. But when faced with the cost and uncertainty of training an 18 year old, many companies opt to let someone else do it.

What can Congress do to help our industry? I think there are several things Congress can do:

1) Pass Association Health Plans! AHP's will empower small business entrepreneurs with the same tools that large employers and labor unions use to make health coverage affordable for working families. AHP's will help expand access to health coverage to millions of the uninsured, and expand health benefits and choices for small business working families who now have only limited options.

2) Pass the Skilled Workforce Enhancement Act (SWEA). The National Tooling and Machining Association tells us it takes $200,000.00 to train a four-year apprentice. Thus, the cost and risk a company takes to hire and train a new employee is very great. Congress needs to pass SWEA and give small companies who want to train, but are afraid the costs could bankrupt them, a $15,000 tax credit per apprentice.

3) Continue to work with the Small Business Administration's Office of Advocacy to ensure common sense is used when considering new regulations.

4) Tell Chairman Greenspan not to raise our interest rates

Chairman Greenspan is under the impression that our economy is rebounding. I hope today, that you all have learned that for the tooling and machining industry, the economy is far from rebounding. I want to thank Chairman Manzullo for his letter to Mr. Greenspan that asked him to consider tooling and machining indicators in his evaluations of the nation's interest rates.

In order for Metz Tool & Die to stay competitive we have to be creative in how we do business. This requires us to invest in newer, safer, cleaner machines. We have to hire and train and retain quality people that can keep us competitive in the market place. To do this we need operating capital. By keeping interest rates down, we encourage new products. When a new product comes on the market, there is engineering to be done, molds to build, production to be run, plating to be done, machining to be done, assembly to be done, packaging and shipping etc.

If the interest rates are raised the cost of money increases, we lose our apprenticeship training because when people aren't making any money, they can't afford apprenticeship training. If the cost of money is high, then we can't buy any of the new equipment we need. If interest rates go up the new products fall by the wayside and then we lose the design, the mold building, the molding, the plating, the machining, and shipping and when we lose all of that we lose our jobs.

We need you to think of America first in all sub-contract work. As always god bless America.

THE QUESTION IS HOW CAN YOU HELP US?

TESTIMONY OF EDWARD W. FEDOR

RESIDENT – MASCO MACHINE, INC.

ON BEHALF OF

AMT — THE ASSOCIATION FOR MANUFACTURING TECHNOLOGY

BEFORE THE

COMMITTEE ON SMALL BUSINESS

U.S. HOUSE OF REPRESENTATIVES

APRIL 24, 2002

TESTIMONY OF EDWARD W. FEDOR
PRESIDENT – MASCO MACHINE, INC.
ON BEHALF OF
AMT — THE ASSOCIATION FOR MANUFACTURING TECHNOLOGY
BEFORE THE
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES
APRIL 24, 2002

I. INTRODUCTION

Good morning. My name is Edward W. Fedor. I am President of Masco Machine, Inc. located in Cleveland, Ohio. We are a small, family-owned, designer and builder of custom metal cutting machinery. We have 60 employees and we provide production equipment to the automotive industry, their suppliers, heavy equipment, agriculture, aerospace and other industries.

Today, I am testifying on behalf of AMT – The Association For Manufacturing Technology. AMT is a 100-year-old trade association that represents approximately 360 machine tool building and related product firms located throughout the United States. Masco has been a member of AMT for over 20 years, and I serve on the Association's Government Relations Committee.

Let me begin by thanking you – Mr. Chairman – for your strong leadership – along with Cong. Neal of Massachusetts – of the House Machine Tool Caucus, which has provided invaluable support and encouragement for our industry.

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 our export offices in China and Mercosur and for our training center in Monterrey, Mexico.

The machine tool industry is small relative to its importance – machine tools are the basic building block for all other industries including automotive, defense, electronics and appliances. If the entire U.S. machine tool industry were a Fortune 500 company it would rank 458th, but everything that is produced or sold by the 457 companies that rank above our industry – and for that matter every other business in America – is either made by a machine tool or by a machine that was made by a machine tool. The majority of AMT members are small businesses. Yet, we build and provide the tools of manufacturing technology to a broad and diverse array of industries. Examples of machine tools include: cutting, grinding, forming and assembly machines; inspection and measuring machines; and automated manufacturing systems. Approximately 30% of our industry's output is exported and, both at home and abroad, our industry competes with machine tool companies from around the world.

I appreciate the opportunity to testify before this Committee to update you on the state of America's machine tool industry, which is not good. Over the past three years, my industry has lost companies and the jobs they provide. Our customers are spending less and imports are rising, as many of our largest customers are looking to foreign plants and overseas suppliers. The combination of the Asian financial crisis and the over-valued dollar has played a major role in the downturn. To compound the problems, many banks have tightened credit for small and medium-sized companies.

II. THE STATE OF THE INDUSTRY

While some economists tout a quick recovery of the U.S. economy, my industry and our customers are looking to late 2002 before orders show even modest increases. Mr. Chairman, I'd like to thank you and the members of your Committee who supported the economic stimulus package recently signed into law by President Bush. The 30% expensing provision included in the package gives my industry a shot in the arm that it so desperately needs right now. Its enactment was AMT's top legislative priority during this Congress. Improving it and making it permanent will be AMT's top legislative priority in the next Congress.

America's machine tool industry is the principal enabler of America's high productivity, which is the key to reversing the economic downtown we are currently experiencing and returning our nation to the economic prosperity to which we have become accustomed. Our industry translates the dizzying advances in information technology into the design of new manufactured products and the factory floor automation that more efficiently produces them.

It is cause for concern that this critical industry is experiencing the worst market conditions in its domestic market since the Great Depression. Orders are off more than 50% since their peak in 1997. Import penetration has shot up nearly 20 percentage points in the past 3 years due to the Asian financial crisis and the weakening of the euro and the yen. Moreover, we have seen increased outsourcing by some of our largest U.S. customers. Five years ago, 55% of our industry's output went to auto companies and the companies that supplied their components. Today, because the Big Three are outsourcing much of their parts manufacturing, only 16% of our products are going to auto companies, while 30% is going to the tens of thousands of "mom & pop" job shops who subcontract for the Big Three.

Since the slowdown in manufacturing started in late 2000, my company's sales dropped off by as much as 50% compared to our sales in the late 1990's. We have had to lay off 16% of our workforce, reduce hours, reduce employee benefits and cut costs in other areas. And unfortunately almost all of our peers have had to do the same or more to simply stay in business.

III. MONETARY POLICY AND THE OVERVALUED DOLLAR

Over the past year and one-half, the Federal Reserve has responded to the economic downturn by cutting interest rates eleven times, and this policy is starting to show results. But despite the recent good economic news, my industry is still suffering. The National Association of Manufacturers recently put out a study that revealed that the recovery has been on two tiers.

Home building and larger publicly held corporations have been able to take advantage of the lower interest rates to regain their economic health. But small and medium-sized, privately held companies, as most of those in my industry are, have not benefited from an easier availability of credit. Tight bank regulatory standards have resulted in credit being diverted from these privately held companies, and many banks have raised their fees or their collateral standards, or both, which has the effect of negating the effect of the lower interest rates from the central bank.

Companies in our segment of the industry typically don't get paid until the equipment we manufacture is shipped to our customers, which means that we have to carry the cost of the equipment for as much as a year before we get paid. And each project can cost a million dollars or more, so you can imagine the interest expense burden and cash flow concerns of the many small businesses in our industry. With the tightening of credit, banks are effectively putting small companies out of business as they refuse to lend to manufacturers like us.

To compound this credit crunch, the dollar has been at record highs. It has appreciated almost 30 percent against the euro, and the yen has fallen from the exchange rate it hit during the mid-1990s, when the range was between 85 and 92, to its current level of approximately 136 yen to the dollar. This has had a devastating effect on my industry. It has the effect of adding a 25 to 30 percent tax on U.S. machine tool products. This is an added cost that no degree of cost-cutting or productivity improvement can overcome.

U.S. manufactured goods exports have plunged $140 billion in the last 18 months, falling more than 20 percent. That drop is principally due to the effects of the overvalued dollar pricing U.S. products out of world markets. This has a much stronger effect on our exports than the relatively mild economic slowdown overseas during that period. When you combine those effects with the impact that has been felt from imports stimulated by that very same overvalued dollar, the result is a manufactured goods deficit last year of $370 billion – a record 25 percent of U.S. manufacturing GDP – twice as large as the previous record.

Since many small and medium-sized companies, such as those in my industry, are likely to take a longer time to recover, we will be very much in need of relief from the effects of tight credit and overvalued currency for some time to come.

Allow me to present one concrete example of what I have been discussing. Recently, our company participated in an online reverse auction for an automotive customer where we were competing with two German companies and two U.S. companies. Our equipment was priced absolutely as low as we could go. The overvalued dollar/undervalued euro permitted our European competitors to undercut our pricing by 30%. There is no way for us to compete with such price advantages.

IV. OUR COMPETITORS RECEIVE GOVERNMENT SUPPORT

Once market share is lost, it is very difficult to regain. In almost every case, our foreign competitors are strongly supported by their governments. U.S. companies are barely able to keep pace with foreign pricing practices. Support from our government is sorely lacking. We rely on your continued commitment to funding government trade programs such as Eximbank and the Commerce Department's trade promotion functions. We also benefit from R&D programs, such at the Commerce Department's Advanced Technology Program, manufacturing extension partnerships, and the DoD MANTECH program, to help us level the playing field and, in some cases, stay one step ahead of our foreign competition.

V. EXPORT CONTROL REFORM

When we do get orders, many times we are unable to fill them as a result of out-dated and rigidly enforced U.S. export control regulations. United States export control policy, particularly with regard to China, puts U.S. companies at a significant disadvantage in obtaining sales to what is likely to be the fastest growing and largest market for capital goods over the coming decade. Statistics we have gathered from official U.S. Commerce Department sources demonstrate that export licenses to China are likely to take from four months to as long as a year for review. Moreover, export license applications for Chinese end-users over the past seven years have been rejected at an almost fifty percent rate by the U.S. government. By contrast, our allies obtain licenses for these very same products to these very same end-users in days, or at most a few weeks. Repeatedly over the past decade, the United States government has taken a negative approach toward machine tool sales to China while our allies have not. The result has been that the Chinese have been denied nothing in terms of high technology, while U.S. firms have lost out in a crucial market. This serves neither our commercial nor our strategic interests. Indeed, the Chinese have begun to warn U.S. machine tool builders to not even bid for new Chinese projects, since many Chinese factory managers' experience with our export control system has been so negative.

My company bid on a piece of equipment for a legitimate Chinese end-user and the export licensing process took 11 months to complete. The whole process appeared to me to be biased toward refusing the license without grounds. This effectively shuts us out of many potential orders in China and deters potential customers from even contacting us in the first place.

Very shortly, you will have an opportunity to reform our outdated and counterproductive export control system, when the Export Administration Act is brought to the House floor for reauthorization. I urge you to work with International Relations Committee Chairman Hyde and the Bush Administration to come up with meaningful reforms that protect our national security and provide a level playing field with our European and Asian competitors and to reject the amendments sought by the Armed Services Committee, which would unilaterally return export control policy to the height of the Cold War.

VI. <u>CONCLUSION</u>

In spite of the hard times we are facing, the United States is still the undisputed leader in developing new manufacturing technologies. Our products remain globally competitive in an increasingly hostile marketplace. However, as the struggle for survival continues, it is getting more and more difficult to maintain our leading edge.

I would note, Mr. Chairman, that if the United States were to lose the domestic core of our machine tool industry, we would become wholly dependent on our allies and trade competitors for the industrial production machinery that fuels our productivity and our keeps our industries on the cutting edge of the latest technology. Without a domestic base for machine tools, Boeing would be second in line behind Airbus; and General Motors and Ford would have to wait behind Toyota before acquiring the latest in production equipment. Being second to market with innovation is not the way to maintain industrial leadership. That is not a situation in which we should want to place our key industrial sectors, which is why a healthy domestic machine tool industry is so important both for national security and for continued prosperity.

That is why I join with you, Mr. Chairman, in asking the Federal Reserve not to raise interest rates during the coming months, as the long awaited recovery begins to gather momentum. Further, I urge members of the Committee to support legislation and public policy initiatives aimed at strengthening America's manufacturing sector, such as the President's recently enacted 30% expensing allowance, which should be improved and made permanent prior to its expiration date in 2004.

America needs a sound export policy, including strong support for export financing and promotion. That means that we need appropriate funding levels for these functions. We also need to pass Trade Promotion Authority so that the President can enhance our current position. We also need a sound manufacturing technology policy with a focus on government R&D programs. The Foreign Sales Corporation (FSC) must be replaced with a WTO-consistent low-rate business tax that is territorial and border-adjustable. America also needs regulatory reform and a strong pro-growth energy policy like the one you passed in the House last year. Finally, our legal system is in need of reform (such as a statute-of-repose for machine tools and other workplace equipment). At the very least, you should not make things worse by permitting employees to sue their own employers under their healthcare plans.

Without sensible government policies, the U.S. machine tool industry, which is critical to America's continued leadership, may be lost. Our industry supports your efforts and hopes to continue to work with you in your efforts to build a stronger America. Thank you, Mr. Chairman. I will be pleased to respond to your questions.

Testimony Howard Habenicht
President & Chief Financial Officer
Vibro/Dynamics Corporation
Before the
House Small Business Committee
April 22, 2002
on
Ramifications of Potential Interest, Rate Hike on Small Manufacturers

My name is Howard Habenicht. I am the President and Chief Financial Officer of the Vibro/Dynamics Corporation, ***and*** a proud member of the National Association of Manufacturers. Vibro/Dynamics is a Broadview, Illinois manufacturer of special mounting systems for heavy machinery. We are a small company, with about 30 employees, but are the recognized technological leader in the installation of metal forming presses in the United States.

About 80 percent of our business is in the United States and Canada, and about 20 percent of our business is export.

Vibro/Dynamics Corporation was founded in 1964 at the time our founder, Mr. Sheldon E. Young, invented a new product that changed the way industrial machines were installed. These products are known as MICRO/LEVEL isolators and over the years new and improved products have been developed. Our isolators have the ability to level industrial machines to micro precision tolerances and provide a method of machine installation that effectively reduces the transmission of impact forces, vibration and noise. In addition, isolators increase a machine's productivity by providing the precise leveling, proper alignment, and uniform support necessary for optimum machine performance. Succinctly stated, our products improve the environment in which both equipment and personnel work. Prior to Mr. Young's invention machines were generally bolted to the concrete floor. Our mounting systems now support machines weighing up to 10,000,000 lbs.

Through Mr. Young's efforts in establishing his business and educating machine tool users of the advantages of his new isolators, thousands of machines in businesses throughout the world have become more productive. In addition, we created a product that has been copied by other US manufacturers who now compete against us. But *fair* competition is good, because it requires us to continue to improve our current products and create new products that will enhance the performance and productivity of machines. Vibro/Dynamics is still the recognized technological leader in the installation of metal forming presses in the United States

There are two issues I would like to discuss today, both of which are of fundamental importance to my company, to the survival of the U.S. machine tool industry, and to the U.S. economy as a whole. These two issues are: the need for affordable capital and the overvalued U.S. dollar.

THE NEED FOR AFFORDABLE CAPITAL

The recession of 2001 will certainly go down in the history books as a business recession, more specifically a manufacturing recession. While the manufacturing sector contracted by 4.1 percent from the second quarter through the fourth quarter of 2001, the entire economy actually expanded by 0.2 percent measured by the GDP quantity index. Moreover, the manufacturing downturn actually began fully six months prior to the "official" start of the recession in March of 2001. The first time such a thing has happened since the end of World War II.

Since the industrial sector was hit hardest during the past year and a half, setting the stage for a recovery in 2002 is critically important to manufacturers, who have lost more than 1.6 million jobs since August 2000. One of the most important elements in fostering a sustainable rebound is to maintain low interest rates. This is critically important for small manufacturers such as myself. While large firms have wide access to capital through bond and equity markets, small firms rely almost exclusively on the banking system for capital.

While a global slowdown and excess inventories were also major factors, the 2001 manufacturing recession was caused by a combination of extremely high capital costs and zero pricing power that combined to erode firms' earnings which forced cut backs in employment and capital expenditures. Concerned by mounting inflationary pressures particularly in the first quarter of 2000, the Federal Reserve pushed up the federal funds rate to its highest level in nine years by July 2000. And despite the fact that inflationary pressures and economic growth moderated in the third quarter, interest rates were held at excessively high levels through the end of the year.

The prime rate, the standard commercial rate, followed suite and rose to a decade-high 9.5 percent by the end of 2000. At the same time, the deflationary trend in manufacturing that began in 1995 continued: prices in the manufacturing sector fell by 2.2 percent last year. Together, high costs and zero-pricing power sent manufacturing profits tumbling from $75 billion in the third quarter of 2000 to less than $2 billion in the first quarter of 2001 – a 98 percent decline.

Although belatedly, the Federal Reserve cut interest rates aggressively, and the Federal Funds rate, now at 1.75 percent, currently stands at a 40-year low. While it may be prudent to increase rates once the expansion gains real and lasting momentum, any move by the Federal Reserve to increase interest rates at this point could very well deflate the emerging recovery that is just beginning.

Just as this was a manufacturing recession, a strong recovery in manufacturing will likely take longer to develop for several reasons.

- The international recovery appears to be lagging growth in the United States, so exports will not likely add a great deal to growth prospects this year. This will disproportionately hurt the manufacturers, who account for two-thirds of U.S. exports and small manufacturers in particular, since more than 9 in 10 exporting manufacturers employ less than 500 people.

- From the first through the fourth quarter of 2001, manufacturing profits only recovered about 10 percent of their losses earlier in the year. This clearly signals that the expected recovery in capital spending will be moderate in 2002. In fact, according to a first quarter 2002 survey conducted by the NAM, 83 percent of small firms (those employing 500 and fewer employees) expect their capital spending plans to grow at an annual rate of less than 5 percent during the first half of 2002, with 75 percent expecting the same for the latter half of the year.

While an inventory rebound will likely provide a one-time positive shock to the economy in the first quarter, the foundations for a sustained recovery in manufacturing have yet to materialize. During the first six months of this year, manufacturing output will likely expand by less than 3 percent. This is roughly half of the growth rate during the first 6 months of a typical expansion. In fact, even with a surprisingly resilient consumer sector and strong government spending in response to September 11, the economy will likely grow about 25 percent slower than the average growth rate during the first year of earlier expansions.

Some may argue that a hike in interest rates may be needed in the near term to squelch inflationary pressures brought about from either excessive activity from extremely low borrowing costs or an inevitable dollar devaluation, which could trigger inflationary pressures.

However, evidence from NAM surveys shows that capital spending for both large and small firms will accelerate only gradually in 2002. Furthermore, this concern does not take into account that, adjusting for inflation, the *real* cost of borrowing for firms, measured as the nominal prime less inflation, is actually still *20 percent above* its 40 year average and *nearly double* what it was in early 1993 before the economy really gathered steam (see chart 1 attached). And, since the Federal Reserve began cutting interest rates in January 2001, prices in the manufacturing sector have fallen by 1.4 percent while overall consumer prices have edged up just 1.7 percent through March 2002.

With respect to the dollar, it is clear that the dollar is overvalued and will eventually come under downward pressure. However, devaluation will not automatically trigger significant inflationary pressures that would necessitate higher interest rates: from March 1985 to May 1987 the dollar fell 33 percent. At the same time the inflation remained under 3 percent while the prime rate fell 22 percent.

The main concern that could trigger inflation is excessive economic growth that outstrips the economy's long-term sustainable growth path, which is determined by growth in the labor force and productivity. With the labor force growth rate likely to rise by roughly one percent per year in the near term, the key to fast sustainable growth is productivity, which, in turn, depends on affordable access to capital that enables companies to equip our country's modern workforce with constantly changing and improving tools and equipment.

With inflationary pressures largely absent, this is the wrong time to argue for higher interest rates, which will increase the cost of borrowing at a time when manufacturers are just emerging from the worst recession since 1982.

THE OVERVALUED DOLLAR

Over the past 10 years we have seen a significant decline in the number of machine tool manufacturers based in the United States, and along with this a frightening decline in U.S. manufacturing jobs. It became evident several years ago that if we wanted to continue our business we would have to develop relationships with foreign machine tool manufacturers who are continually increasing their imports into the United States.

We have had some success, but it has not been easy. In September, 2000 the only surviving US builder of large presses, and at the time our largest customer, went bankrupt. The large press builders are now found in Germany, Japan, and Italy - none in the United States! Every U.S. manufacturer of large presses is now gone. This has serious consequences.

One of the European press builders had been telling their customers that if they used Vibro/Dynamics mounting systems for installing their presses, they would not honor their warranty. It just so happened that they recommended a European manufacturer for the installation of isolation mounts. After several visits to Central Europe and numerous contacts with this press builder's representatives, we have achieved the position of now being one of the acceptable providers of isolation mounting systems for their presses. Gaining this acceptance took us about two years and a lot of time and money.

However, it appears that all of our efforts have been in vain. Although we are now able to quote our systems for their machines, we find that we cannot match the prices offered by our European competitor because of the significant dollar markup. This dollar value situation affects our business in Japan and Canada as well. This is significantly hurting our business. Because so many of our U.S. based machine tool manufacturers have failed due to the competition of foreign manufacturers, we must principally look to those foreign companies to replace the customers we have lost. And now we find we can't compete because of the strength of the U.S. dollar.

We have recently had to reduce our work force by 30% and impose 10% pay cuts to everyone else – a direct consequence of the effect of the dollar's over-valuation against foreign currencies. Last year was the first time in our 36 year history that we lost money. Even during the start-up years when Mr. Young operated from his basement, Vibro/Dynamics never lost money. We are operating now in a "survival mode."

I believe in fair trade and fair competition. We have the best workers in the world right here in the United States, and our productivity continues to out pace that of other countries. Unfortunately we cannot make-up for a dollar-induced "surcharge" of 35 percent! The excessively high dollar enables manufacturers of products like ours based in Europe to quote prices considerably lower than ours – despite our productivity improvements and the determined efforts of our excellent workforce.

We have found that we can buy a complete finished product like ours from manufacturers in Europe at a lower cost than our products cost to produce. That is not because they have improved their productivity more rapidly than ours in the last few years. Nor is it due to any slackening of our own productivity improvements. And it is not due to price increases in the United States. It is due solely to the fact that against our competitors the dollar has risen by over 30 percent.

Because of the overvalued dollar we are now forced to consider seriously buying some products in Europe, for use on smaller machine tools, rather than continuing to try to produce these ourselves. We need to find ways to lower our costs to that we can overcome the "exchange rate penalty", and this means purchasing component parts overseas rather than here. How ironic that we were selling our finished products there, and now we are reversing that and are looking at buying from them instead. That means lost U.S. jobs.

And we are not alone! I hear from many other manufacturing companies that they are experiencing the same difficulties. The National Association of Manufacturers, using U.S. government data, has found that U.S. manufactured goods exports have fallen $140 billion in the last year and a half. That is an astonishingly large number. In fact, the NAM estimates that this decline, which is principally due to the overvalued dollar, is so large that it has accounted for two-fifths of the entire decline in U.S. manufacturing employment – that's four out of every 10 unemployed factory workers.

How is it possible that the dollar has retained its strength in light of our slowing economy, rising unemployment, and declining interest rates? I'm not a monetary economist – I run a company. But I know that it is time for the U.S. Government to stop extolling the virtues of a strong dollar at any costs and start advocating and working for a realistically-valued dollar.

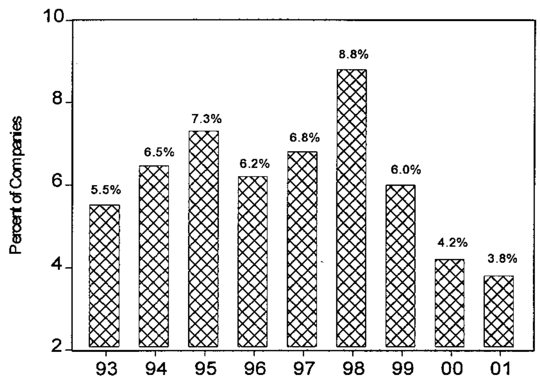
All this happened before, in the mid-1980s, when the U.S. government let the dollar get higher and higher until it finally acted. The dollar quickly came back to reality once the U.S. government stated it was overvalued and announced it and other governments were going to take coordinated action to bring currencies back to a reasonable relationship with each other.

If this Committee is truly concerned with the future of small business, then I urge this committee to press the Treasury to take whatever actions may be necessary to eliminate the artificial inflation in the value of the US dollar. I can tell you that if our government does not take these steps, many more U.S. manufacturing companies will be lost, and more of our manufacturing base will be threatened.

Thank you, Mr. Chairman.

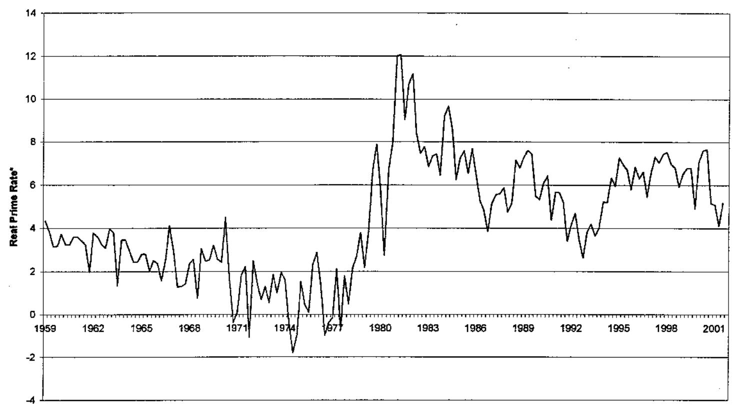
EXPORT GAINS OF SMALLER MANUFACTURERS ERASED BY DOLLAR OVERVALUATION IN LAST THREE YEARS

Percent of Small and Medium-Sized Manufacturers Exporting at Least 25 Percent of their Production Plummets to Lowest Level Since 1993



Source: Annual NAM surveys of small and medium-sized manufacturers

Chart 1. Real Prime Rate



*Prime Lending Rate minus inflation (measured using the GDP deflator)

Source: NAM calculations from Federal Reserve and Commerce Department Data

Sara P. Garretson
Industrial & Technology Assistance Corp.
Testimony to the House Committee on Small Business
April 24, 2002

Mr. Chairman, Members of the Committee, thank you for giving me this opportunity to speak to you about the impact of interest rates on our country's small manufacturers. I will speak to this issue by discussing the impact of high credit costs and low accessibility on the productivity and competitiveness of our nation's small manufacturing firms.

I am Sara Garretson, the President of ITAC, the Industrial & Technology Assistance Corp. ITAC is a not for profit economic organization whose mission is to improve the NYC economy by assisting our local manufacturing firms to improve their performance. Our work is significantly made possible by the Manufacturing Extension Partnership (MEP), a Federal program managed through the National Institute of Standards and Technology. The MEP is a network of over 60 centers with 400 locations across the country and in Puerto Rico, providing technical assistance and business support services to America's small manufacturing firms. Together, these centers employ more than 2,000 professionals who work with manufacturers to ensure that they are adopting and using the latest and most efficient technologies, processes and business practices. MEP services help manufacturers to be more productive, competitive, and profitable. This means more jobs; more tax revenues at the local, state and national levels; more export and trade activity; and a more secure supply chain for consumer and defense goods.

Role of Manufacturing in the U.S. Economy

A recent study of the National Association of Manufacturers found that the manufacturing sector makes the highest contribution to our nation's economic growth, and leads the nation in the productivity growth which was largely responsible for the increase in the nation's standard of living in the last half of the 1990's. Manufacturing contributes 16% of the Gross Domestic Product. Manufacturing employees earn $44,778 average annually -- 27% higher than the U.S. average for all industries. 80% of U.S. export revenue is manufactured goods.

While many of us think about the large firms like General Motors, General Electric or Cisco when they think about manufacturing, in fact the small manufacturer is a key component of our nation's industrial base. There are 355,500 small manufacturers in the U.S. – making parts for Boeing or GM, producing foods for our markets, products for our retail stores – they feed, clothe, house us – and they provide the critical components for many of our exported products, our defense technology, our transportation infrastructure. 95% of all manufacturing firms in the U.S. are small manufacturers. Most of them are family-owned businesses. These firms provide employment for 11.3 million Americans – two-thirds of all manufacturing employment.

Key Issue for Small Manufacturers: Access to reasonable cost credit

Almost ten years ago, I had the privilege of participating in a National Research Council Committee called "The Committee to Assess the Barriers and Opportunities to Improve Manufacturing at Small and Medium-sized Companies". We produced a study entitled "Learning to Change: Opportunities to Improve the Performance of Smaller Manufacturers". The Committee identified five barriers to manufacturing performance improvement in small firms: including the regulatory environment, lack of awareness of modern technologies and practices, isolation, and scarcity of capital. The study found that small manufacturers lacked access to operating capital and investment funds for modernization.

Has this situation changed? There were a few years in 1998 and 1999 when debt was relatively easy to access. But recently, the National Association of Manufacturers completed a survey on credit rationing. One of the survey's conclusions was that "more than a third of small and medium size manufacturers are finding it more difficult to obtain credit from their longstanding bank lenders -- a trend that threatens to undermine our economic recovery". For those firms having the most difficulty obtaining credit, 60% report that their cost of borrowing was unchanged or higher, in spite of repeated interest rate reductions by the Federal Reserve. The NAM study recommends that it be a high priority to improve the flow of credit to business.

Why does this matter?

- If we are to recover from the current recession, then we need small manufacturing firms to invest in their future – by improving their productivity and developing new products and markets. These firms can drive the recovery – but only if we give them the means to do so.
- Higher interest rates on working capital financing drives down profits, thus reducing the business owners' ability to invest their own funds in the future.
- Investments in productivity improvement pay back many times by providing the firms with long term cost reduction or new product opportunities.

Investing in Productivity Improvement brings high returns to small firms:

Would firms actually invest in productivity improvement if they could access the financing at a reasonable cost? Another recent NAM survey showed that small manufacturing firms want to make these investments in their future: 87% want to invest in marketing and sales, 86% want to improve their manufacturing processes, 79% want to develop or improve existing products, and 77% want to invest in training their workforce.

At ITAC, like with other MEP Centers, we frequently witness the payback of these investments. Our job is to assist the small manufacturer to adopt new technologies, new processes, develop new products or new capabilities.

I would like to illustrate with a couple of examples from firms we have helped from Congresswoman Velazquez' District in Brooklyn.

Grand Processing Inc. services the local textile knitting industry by dyeing, drying and returning rolls or pieces of textiles to manufacturers for sewing. The company employs approximately 75 people. In today's market, they are expected to provide high quality and 24-48 hour service. They originally came to us for help in reducing their very high energy costs and to reduce their turn around time. One of our client managers worked with the company to develop a project using a new, innovative technology adapting microwave drying for textiles. This process avoids fabric shrinkage, color fading and allows rapid drying. When the machine becomes operational, Grand Processing will reduce their energy costs to one fifth of the current level, the machine will dry the textiles in one fifth the time, using one fifth the labor costs. This project cost $350,000 and it is highly unlikely that a bank would finance such an undertaking. Fortunately for this company we were able to tap into some public sector financing through the NYS Energy Research & Development Authority. But the point remains: invest in productivity and it provides a return every year back to the company.

The Israel Beigel Baking Co. traces its baking history to the late 1800's. It began baking in Williamsburg, Brooklyn after World War II. Their products, which include breads, rolls, cakes, pastries and cookies are now distributed through the US, including Costco. The firm employs approximately 75 local people. Several years ago, the Beigel Co. came to us because they were using a turn of the century polluting oven for baking their bread. They were throwing out up to 15% of production because of its poor quality. The current owner felt that he could not remain viable with such high production costs. We helped the firm to purchase a high technology baking oven. When this oven goes into operation, the process will allow for continuous baking without any pollutions and it will eliminate the waste of rejected breads. In addition, the oven design will allow the company to bake a new product line of 100% organic breads without preservatives that will eventually be distributed nationally. How was this project financed at a reasonable cost? Once again we were able to help the firm access public sector resources.

I use these examples to demonstrate how these investments in the future can strengthen our manufacturers. In these cases we were able to tap into public sector resources, But there are not enough public sector resources to meet demand. Companies like these two need to be able to access reasonable private sector financing where they can service the debt and take the risk for a more profitable future.

The MEP investment provides benefits to the nation

Before I close, I want to say a few words about the Manufacturing Extension Partnership. As I am sure you are aware, this program is in danger of elimination, because the proposed Administration budget for FY 2003 reduces funding from $106.5 million to $12.9 million. MEP is a cost-beneficial investment on the federal government's part. Independent studies show that MEP services increase corporate and personal tax revenues, both by significantly growing before-tax profits of small manufacturers and by stabilizing or growing the manufacturing workforce. A conservative return on investment on federal spending is that the MEP program returns at least $4 in federal tax revenue for every $1 it invests in the MEP. Reducing funding for this program reduces federal tax revenue four-fold. For FY 2000 only, MEP client firms reported $2.3 billion in increased and retained sales, cost savings of $483 million, and more than 25,000 jobs created or retained. Significantly, the surveys also find that MEP involvement is a catalyst for additional modernization by firms, which reported over $883 million in new investment as a result of MEP services.

Summary:
To summarize, our small manufacturers are an important part of our economy – past, present and future. Our country and our economy need to make sure they have the means and the knowledge to invest in their future success. The MEP provides the technical support that firms may need to invest wisely and successfully; but they also need to be able to access reasonably priced financing. In both the projects described above, we were able to bring to the company the technical expertise as well as assistance in accessing the means to finance its implementation. Keeping interest rates low during this critical phase of the economic recovery will help to make the means available for these investments in the future.

Mr. Chairman, again I thank you and the Committee for the opportunity to appear before you today, and I will be happy to answer any questions you may have.

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U.S. HOUSE REPRESENTATIVES

COMMITTEE ON SMALL BUSINESS

HEARING ON

INTEREST RATE HIKES AND THE AFFECTS ON STRUGGLING SMALL MANUFACTURERS

APRIL 24, 2002

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STATEMENT FOR THE RECORD
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON SMALL BUSINESS

HEARING ON
IMPACT OF INTEREST RATE HIKES ON STRUGGLING SMALL MANUFACTURERS
April 24, 2002

The American Forest & Paper Association (AF&PA) appreciates this opportunity to comment on how small business manufacturers are impacted by current economic conditions. Increases in interest rates or any other policies that would increase the cost of capital on U.S. manufacturers would seriously threaten the prospects for economic recovery in this sector. While overall the U.S. economy appears to be improving slightly, the manufacturing sector continues to struggle. One reason in particular is the overvalued dollar, which undermines the ability of U.S. manufacturers to compete for sales—both here and abroad.

AF&PA is the national trade association representing the producers of paper, pulp, paperboard and wood products, as well as growers and harvesters of this nation's forest resources. Our industry employs approximately 1.7 million people in 42 states, with an annual estimated payroll of $51 billion, and annual sales of more than $250 billion. AF&PA's membership encompasses the full spectrum of U.S. businesses ranging from small family owned manufacturing and tree farm businesses to large integrated companies.

In addition, AF&PA manages the American Hardwood Export Council (AHEC), a trade association representing hardwood exporters who service the global demand for U.S. hardwood. Nearly 70% of AHEC member companies are small, often family owned enterprises that operate in rural areas. In many cases, AHEC companies still carry the name of their founder and are now managed by third and fourth generation family members. These companies play a key role in providing employment opportunities in small, rural communities across the country.

A critical issue facing small manufacturers today is the overvaluation of the dollar. Since 1997, the dollar has risen by 25-30% relative to a basket of major world currencies. The dollar is now at a sixteen year high and is approaching the overvaluation of the mid-1980's. The U.S. current account goods deficit is expected to exceed $500 billion or more than 5% of U.S. GDP in 2002. More importantly, the trade deficit in manufactured products has soared from 10% in 1997 to more than 25% of manufacturing GDP in 2001. Potential interest rate hikes will even further exacerbate an already dismal situation. Higher U.S. interest rates will attract even more overseas investments in U.S. dollars by increasing the rate of return. This in turn will drive up the value of the dollar even further.

The U.S. forest products industry is deeply involved in the global market. In 2001, exports of U.S. wood and paper products exceeded $19 billion. Wood product exports were the top rated agricultural export in 2000. Hardwood lumber exports top the list of all wood products in both volume and value terms. In 2001, hardwood lumber exports were valued at $1.2 billion. However, many companies have watched a steady decline in their hardwood export business over the past two years, particularly because the overvalued dollar imposes a de facto tariff of 25% on U.S. producers selling into foreign markets.

The overvalued dollar is effectively subsidizing our foreign competitors. Despite concerns over quality and delivery reliability, Eastern Europe has emerged as a significant supplier of sawn hardwoods to Europe -- the largest export market for U.S. hardwoods with the highest product unit values-- greatly assisted by the continued strength of the dollar and the weakness of the Euro. Eastern European mills have stepped up production as U.S. hardwoods struggle to match their price. The net result is that U.S. hardwood exporters have lost key European markets that they will never get back. As an example, one company had to reduce its pricing by 20 percent for its products sold to Italy because of the strength of the dollar, resulting in a loss of about $400,000 last year. The same company had to reduce its price 30 percent to meet the same volume sold to Norway, resulting in a total loss of approximately $250,000. Since February 2001, another company lost 35% of its volume of lumber exports to Egypt because of the exchange rate -- this amounted to a third of the company's business or $1 million.

Small family owned businesses are struggling to hold on to their overseas customers, but at a significant cost. At the same time the strong dollar tariff affects our exporters it also applies to U.S. domestic shipments. Foreign competitors now have a major cost advantage in our home market -- magnified in industries such as ours where U.S. tariffs are low or zero. The impact of the overvalued dollar on the U.S. forest products industry, and the hardwood industry in particular, has been devastating. The hardwood business has been battered by cheap imports, which has resulted in a ripple effect across manufacturing interests. In addition to the general slowdown in the U.S. economy, the domestic furniture industry, one of the largest traditional users of hardwood lumber and veneer, has been contracting rapidly. It has been estimated that as many as 75 furniture plants closed in the first half of 2001 alone. Rapidly growing furniture imports, particularly from China, which is emerging as a low-cost supplier of increasingly high quality furniture, are largely to blame. The persistently strong dollar has made these imports relatively cheaper, while hampering the competitiveness of US exports.

For wood products, the combined effect of weakening export markets and surging imports has put unprecedented downward pressure on wood product prices in the U.S., forcing many lumber producers and wholesalers out of business. Approximately 20 mills with a capacity of 1.7 billion board feet were shutdown permanently in 2001. Total wood exports have declined by 16.6% over the past year, accounting for a $1 billion loss. Since 1997, exports have declined by 27%. Since 1998, the lumber and wood sectors have lost 23,000 jobs. These are high paying jobs most often located in rural communities where the mills are the backbone of the local economy. Just in the last year, 10 hardwood sawmills have closed their doors **permanently**, resulting in a loss of over 500 jobs.

On the pulp and paper side of the industry, between the period 1997 – 2000, U.S. domestic demand for paper products grew by 3.5 million tons, but imports took more than 90% of that growth. In the last five years, U.S. paper companies have had to close 72 mills. That's an average of more than 14 mills per year – compared to an average of less than four per year in the early 1990's. In 2001, U.S. paper industry exports were down by $1.5 billion from the 2000 level. Imports were lower as well last year -- off $900 million -- but they were $3.3 billion higher than in 1997. Therefore, the U.S. trade deficit in paper industry products has ballooned from just $273 million in 1997 to $3.8 billion in 2001. According to a report by SalomanSmithBarney, the overvalued dollar has robbed U.S. paper companies of their long-standing competitive advantage vis-à-vis European suppliers. The report predicted that U.S. paper companies will not return to profitability until this disequilibrium in the dollar-Euro rate is fixed. The plight of larger paper companies clearly impacts numerous small businesses throughout the supply chain.

Traditional wisdom argues that, while exchange rates fluctuate over time, tariffs are forever. The argument suggests that short-term strategies can address exchange rate effects and tariffs should be regarded as the structural, long-term concern. In this case, however, traditional wisdom has proved a less-than-reliable guide. The normal adjustment triggers -- burgeoning U.S. trade deficit, lower U.S. interest rates, slowing U.S. growth -- have not worked. The persistence of the overvalued dollar has forced industries, including our own -- to close plants. Other industries have moved production facilities offshore. Unless the exchange rate is fixed soon, when equilibrium is restored, the U.S. forest and paper products industry will not have the capacity to challenge our competitors to retake our lost markets.

The Omnibus Trade and Competitiveness Act of 1988 recognizes the nexus between exchange rates and the benefits the U.S. actually realizes from trade agreements. It requires regular monitoring and reporting of potential currency manipulation by other countries. Such actions can rob the U.S. of negotiated market access rights and, at the same time, unfairly advantage foreign suppliers in the U.S. market. Today, there is clear evidence that some foreign governments, to establish competitive advantage for their industries, are manipulating foreign exchange values. These countries -- particularly Japan, China, South Korea and Taiwan -- have accumulated dollar holdings well in excess of recognized or necessary reserve requirements for the purpose of depressing the value of their currencies and maintaining export price competitiveness.

AF&PA believes the relationship between exchange rates and trade policy must be subject to further scrutiny in light of the current, sustained overvaluation of the U.S. dollar. It is important that Trade Promotion Authority (TPA) legislation also deal with the effects of exchange rate fluctuation that can negate the economic benefits of any tariff reductions negotiated by the U.S. on behalf of U.S. industry. The House bill provides for the establishment of consultative mechanisms among parties to trade agreements to protect against currency manipulation by foreign government. We believe this is an important safeguard to ensure that the U.S. realizes the benefits they negotiate on behalf of U.S. manufacturers and strongly support its enactment.

It is important to emphasize that, unlike any number of other competitiveness issues where affected industries have some ability to adopt reactive strategies, exchange rates are solely and exclusively the domain of the Administration. This means that unless and until there is change, the only realistic strategy for many companies is to stop running manufacturing their products.

So what can be done about this problem? Using history as a guide, the last time the U.S. manufacturing trade deficit ballooned in response to an overvalued dollar, the Reagan administration entered into the so-called "Plaza Accord." This agreement, signed by the United Kingdom, France, West Germany and Japan, provided for concerted action by the major industrialized nations to lower the value of the dollar and reduce the trade deficit. The intervention was modest in scope, involving $8 billion in dollar sales by European and Japanese central banks and $2 billion of foreign currency purchases by the U.S. Federal Reserve. At that time, the Japanese yen was the primary target of intervention.

While the Plaza Accord worked in the mid-1980's it is not the only option available to bring the value of the dollar back to more reasonable historic levels. In currency markets, U.S. government rhetoric means a lot. Signals from the U.S. Treasury that the it supports a sound dollar that is consistent with the economic fundamentals of the U.S. economy could help erase the current world-view that the U.S. will let the value of the dollar continue to rise. Later this spring, Finance Ministers of the G-8 are scheduled to meet. The value of the dollar vis-à-vis other major currencies could be a topic for discussion. Discussions alone would send signals to the marketplace that underlying economic fundamentals matter and the U.S. does not intend to walk away from its manufacturing base.

AF&PA, and our member companies, fully support Administration and Congressional efforts to open overseas markets for our products. We are working with our collegial industrial organizations in other countries to broaden business community support for a global tariff free environment for our products. At the same time, we join with the growing ranks of U.S.-based manufacturing industries in identifying the overvalued dollar as the single most compelling threat to the economic viability of our companies, both large and small. Urgent and effective action to restore the U.S. dollar to a level, which reflects the underlying fundamentals, is essential to restoring a globally competitive U.S. small manufacturing sector. We look forward to working with the Small Business Committee to ensure that government policies are consistent with a strong manufacturing sector in the United States.

DONALD A. MANZULLO, ILLINOIS
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Congress of the United States

House of Representatives

107th Congress

Committee on Small Business

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March 20, 2002

The Honorable Alan Greenspan
Chairman
Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, D.C. 20551

Dear Dr. Greenspan:

As you may know, I represent northern Illinois, including Rockford, which has the heaviest concentration, per capita, of machine tool and tool and die companies in the nation. As Chairman of the Small Business Committee and also as a Member of the Financial Services Committee, I have seen the combination of the Asian financial crisis and the over-valued dollar have made the past four years particularly tough ones for these industries nationwide. This type of manufacturing performed is usually the first to suffer during an economic decline and the last to recover in an upswing. Machine tool production in the United States alone is down 50 percent from its peak in 1997. Rockford led the nation in unemployment in the early 1980's at over 25 percent and now counties in northern Illinois are experiencing unemployment rates two or three percentage points higher than the national average.

Over the past 18 months, you have responded to the economic downturn by cutting interest rates 11 times, and this policy is starting to show results. I am grateful that the Federal Reserve decided yesterday not to raise interest rates. But despite the recent good economic news, both machine tool and tool and die makers still suffer, as reported to me by the Association for Manufacturing Technology (AMT) and the National Tooling and Machining Association (NTMA). The National Association of Manufacturers (NAM) issued a recent study, which was highlighted at an access to credit roundtable discussion I held on this subject on March 1, 2001, that revealed the recovery has been on two tiers. Home building and larger publicly held corporations have been able to take advantage of the lower interest rates to regain their economic health. But small and medium-sized, privately held manufacturing companies, as most of the machine tool and tool and die companies are, have not benefited from an easier availability of credit. Tight bank regulatory standards have resulted in credit being diverted from these privately held manufacturing companies, and many banks have raised their fees or their collateral standards, or both, to negate the effect of the lower interest rates from the central bank.

To compound this credit crunch, the dollar has been at record highs. It has appreciated almost 30 percent against the Euro, and the yen has fallen to 136 to the dollar from its levels in the high eighties. This, too, has had a devastating effect on the manufacturing industries not just in northern Illinois but also in most other areas of the nation. It is a competitive tax on them that no degree of cost-cutting or productivity improvement can overcome.

I would, therefore, respectfully ask that you to take these factors into consideration as you manage central bank interest rates over the coming year and as you set the bank regulatory standards along with the Comptroller of the Currency. In particular, I strongly encourage you to use the monthly U.S. Machine Tool Consumption report released by AMT and the American Machine Tool Distributors' Association (AMTDA) as a key indicator of the overall health of the economy. Many small and medium-sized manufacturing companies, such as those producing machine tools and tool and dies, are likely to take a longer time to recover than other manufacturing sectors and will be very much in need of relief from tight credit and overvalued currency for some time to come. I thought that it would be useful to bring these issues to your attention.

Sincerely,

Donald A. Manzullo
Chairman

cc: John D. Hawke, Jr., Comptroller of the Currency
Federal Reserve Board of Governors

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