NATIONAL MACHINE TOOL BUILDERSASSOCIATION
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I want to spend some time with you this morning discussing the state of industry in theUnited States and its future in a more competitive world. I would suggest that while "industrialpolicy" in the sense of picking winners and losers appears to have met a well-deserved fate, wewill not retain our position of world economic and political leadership unless we can agree onand implement a strategy for industrial survival. That, in turn, will require the re-learning of some old lessons - on exchange rates, interest rates and tax policy, for example -- as well assome new learning to understand how our world trading system has changed.

A popular topic at conferences these days throughout think tanks in Washington is thedeindustrialization of America. Economists, columnists, political scientists and other assortedpundits have produced reams of paper studying this question. Even though America may bedeindustrializing at a rapid pace, I can tell you there is one real growth area -- and that is foreconomists.

The most interesting aspect of this debate, however, is its proof of the old adage,"Where you stand depends on where you sit." Most economists, who have never madeanything, have rejected the deindustrialization argument, because it does not conform to conventional theories.

Most businessmen, on the other hand, understand the argument very well becaue of theirown experience with increased imports from foreign competitors and restricted access to foreignmarkets.

By now, however, our trade and investment problems have been so serious for so long,that even economists can no longer deny their existence.

Indeed, there is no better place to look for proof than the report of the President'sCommission on Industrial Competitiveness which came out in January. Among other things,that document reports:

- Beyond our $123 billion trade deficit, we are losing market share in industry afterindustry, and not just in "old" industries like steel and textiles. In high technology, for example, we have lost world market share in 7 out of 10 categories.

- In your own industry, imports' share of our market has risen from 10.3% in1974 to over 40% in 1984. Imports' share of the market for machining centers has increasedfrom 11.3% to 56% in just five years.

In part this is due to market restrictions elsewhere. In part we have inadvertentlybrought this on ourselves. For example:

- Although we spend huge sums each year on research and development, spendingon "civilian• R&D -- that is, non-space and non-defense -- is less than in Japan and Germany asa percent of GNP.

- Japan, with half our population, is graduating more engineers. They have theadded advantage of graduating 1/20 as many lawyers.Œ - American fixed investment as a percent of GNP lags behind Japan, France, Italy,Germany, and Canada, as does our labor productivity. As the President's Commission reports, "Nations that invest more also have greater productivity growth. The United States rankspoorly in both of these areas when compared to our major trading partners."

- Over the past twenty years, real rates of return on manufacturing assets havedeclined. In the past four years they have fallen below the rates for alternative investments. We are sending investors a clear signal about where they should put their money.

- And we are raising the cost of that money. Our savings rate lags behind ourdeveloped trading partners, while our cost of capital is much higher, twice as high as Japan's.

- These developments are reflected in employment trends as well. Although wehave created six million jobs during the current recovery, they are primarily in services. Total manufacturing employment is still lower than in 1981. And in 41 states it is below the levelof 1971. Total employment is still below 1979 levels in 17 states.

- Finally, the overwhelming impact of exchange rates has influenced all thesedevelopments. The dollar has appreciated over 40% in value in the Reagan Administration. As the dollar has gone up, our trade and current account deficits have soared with them. (referto charts) And companies have responded accordingly. Caterpillar, for example, is closingdown two of its modern facilities here in favor of new production in Korea, Scotland andBelgium. That kind of action is irreversible.

These details document what you in this room already know and what the President'sCommission has publicly reported:

"Our ability to compete in world markets is eroding . . . U.S. leadership in world tradeis declining . . . The U.S. position as a world leader . . . depend(s) on the ability of Americanindustry to compete both at home and abroad."

We have reached this point through a combination of missed opportunities in trade policyand misunderstandings in tax and investment policy.

In part, the international trading system has been changing faster than we can adapt toit - or even understand it.

For instance:

- The increasing sophistication and speed of transportation and communication havecreated a true world market. Who would have thought ten years ago that over half ofAmerica's daily supply of fresh carnations and chrysanthemums would come from Colombia,Israel, and Europe?
- The decline in the rate of domestic economic growth has made foreign marketsmore important, both to our producers seeking growth and to others who seek to take advantageof our open market for their growth.
- Developed countries have failed to pursue and successfully implement adjustmentpolicies for industries that are no longer competitive, preferring instead to subsidize productionand employment and export the costs of that policy to us.
- Non-western trade players have moved to center stage; yet their standards andbusiness practices often dramatically conflict with the trade system we and our European allies created after World War II. For example, one of the critical new problems we face isprotecting our intellectual property against the piracy and counterfeiting of unscrupulous individuals in a handful of countries.
- And we in America -- both smokestack and high tech industries -- know frompersonal experience how hard it is to acknowledge and adapt to the progress that some LDCs are making in industrialization, the other side of that coin is the LDCs' failure to accept theadditional responsibilities that come along with development.

Now what does all this mean? It means that the trading system is changing too fast andbecoming too complex for our policy institutions to keep up. Old rules, old practices, oldphilosophies -- like free trade -- do not fit anymore. Our underlying assumption of the post-war era -- U.S. world economic dominance -- is simply no longer true. And therefore ourunderlying policy premise -- unilateral free trade -- is no longer relevant. It may be ideal, butwe are not living in an ideal world. and in a second-best world, you don't insist on first-best policies. Or, as my colleague Jack Danforth has said, when you have a $123 billion tradedeficit, maybe it's time to cheat a little.

These changes are challenges a healthy economy and a creative people can meet. Theproblem is the Administration's failure to address them.

Very simply, we have for 4 years pursued a policy of benign neglect of internationaltrade and financial systems. Even more, we have been proud of our ignorance.

- the dollar's appreciation, out of control and out of proportion has become a signof strength.
- non-tariff barriers imposed by others against us are really signs we're not tryinghard enough to sell our goods.
- the failure of our manufacturing sector to share in the economic recovery is asign we are becoming a more sophisticated economy.
- when shoe workers in Maine are unemployed, that is, apparently, in the wordsof one ITC Commissioner, their own fault for not moving.
- trade deficits, like the budget deficits of only two years ago, apparently do notmatter. Although I'm still waiting for the supply siders to tell us we can grow our way out of them.

This approach to the global economy is like Alice in Wonderland. The effect of ournon-policy is the same as telling American industry "off with your head," and the long termresult will be to leave us with little more than the Cheshire cat's grin instead of a live body.

There have been some recent signs the Administration is waking up; most of them havecome from the Treasury Department, notably our agreement to discuss international monetaryissues with our allies and trading partners.

Congress is waking up too, but slowly. Recent hearings in the Finance Committeeclearly made the case for better coordination of fiscal and monetary policy among the majortrading countries, including agreement on coordinated intervention in the exchange markets asa part of that larger policy.

Congress also established the case last year in the Trade and Tariff Act of 1984 for amore aggressive attack on non-tariff barriers. We have given the President the tools he needsfor that purpose. His continued failure to use them -- like in the Houdaille case and the Administration's failure to develop a coherent policy -- will only force Congress to do his workfor him.

Unfortunately, our tools are considerably blunter -- and more protectionist. Theyinclude sledgehammers like an import surcharge and outright retaliation like John Chafee's billto prohibit Japanese telecommunications importers.

In the case of Japan, my own view is that such a hard line approach is both necessaryand inevitable.

From a narrow point of view, the Japanese system has been extraordinarily successful. Through adroit management of their currency and capital market, through careful governmentguidance and the close cooperation of groups in their society that in our country are dedicated adversaries, the Japanese have created a dynamic growing economy well-positioned to takeadvantage of technological change.

But there is a cost to such an industrial poilcy that we cannot ignore, because it is weand others outside Japan who pay it.

In some sectors products that can compete are simply excluded -- blatantly as inagriculture, subtly as in many industrial products.

In other sectors foreign competition is excluded only until the Japanese have an equal,or superior, product. Then, when it doesn't matter anymore, the door is opened. The resultis market distortion...perhaps more clever, certainly more successful, but the person with thebetter idea -- with the competitive edge -- is out in the cold, unless, of course, he's Japanese.

One nation practicing this system is a problem. If every nation practiced it, commercewould be paralyzed completely. Yet the trend, at least in Asia, is to copy the system, givenits obvious success.

The issue here, of course, is not simply erasure of our trade deficit with Japan. Themost optimistic estimates suggest that completely open markets would only eliminate about halfof it, and beyond that I have no intention of trying to repeal the law of comparative advantage. What the Japanese must understand, however, is that their policies, no matter how good theyare for Japan, have consequences for us as well. And we must act in our interests, not theirs. That is not protectionism. That is not racism. That is not starting a trade war.

Indeed, the trade war has already begun. Japan started it over 20 years ago, but all thecasualties are on this side of the Pacific.

Right now we are locked into an increasingly destructive cycle with Japan in which wecomplain, they produce a reform program -- six since 1981 -- we wait a few months and thendiscover it's meaningless, and then complain again. They are unable or unwilling to take ourproblem seriously. We are unable or unwilling to persuade them to do so.

That is why I have introduced legislation calling for a twenty percent surcharge for threeyears on all Japanese imports. That will demonstrate our seriousness and break the cycle. Asurcharge has been criticized as being disruptive. To my mind, that is the strongest point inits favor. We have to disrupt the current relationship if we are to build a healthier one. Andthat means creating in Japan the political will -- based on necessity --to act and to change.

Japan, however, cannot be the sole focus of our international attention.

We need new approaches to opening up the trading system -- by encouraging ourexporters and improving their market access.

We need to continue our efforts to remove our own barriers. Most critical there is ourdefense of the beleaguered Export-Import Bank. To destroy the Bank, as Dave Stockman hasproposed, in the face of a high dollar and increased foreign competition is to tell our most sophisticated industries they have no role on the international stage. Aircraft, power generation- conventional and nuclear - and other major sectors affecting thousands of prime andsub-contractors are being told there is no alternative to surrender in the export credit war.

And we should continue our efforts internationally to defend the market system byfighting dumping, subsidies, and non-tariff unfair trade practices that distort comparativeadvantage.

I will shortly be introducing comprehensive trade policy and reform legislation supportedby the Labor-Industry Coalition for International Trade (LICIT). I urge you to review the provisions of this important legislation, as it truly embodies a trade policy for the 1980s and 1990s.

And it is here where I differ from the suggestion by Senator Danforth, and also froma group of Democratic Senators, that we should hold new negotiating authority hostage to thedevelopment of a sounder policy by the Administraiton. In my judgment, such a proposal isa straw man which allows the Congress once again to avoid tackling the real issue, which isthe enactment of legislation creating a more aggressive policy, in favor of continued discussionsthat have proven endless -- and useless -- thus far.

As I indicated earlier, deindustrialization is not just a problem of trade policy. Anotherpiece of the puzzle is the failure of the Administration to sustain the pro-investment philosophythat was the hallmark of its first tax bill.

Today's buzzword seems to be "tax neutrality", whatever that means. Unfortunately,even if we knew what it was, we would be hopelessly naive to build our tax system withoutregard to the advantages our competitors' tax codes confer on their industries.

The Administration apparently still clings to the belief that we can grow our way out ofour deficits, and that the continued rate reduction of its tax proposal will be the engine for thatgrowth. But the overall effect of the proposal is to discourage investment and savings in favorof consumption, largely through repeal of Accelerated Cost Recovery and the Investment TaxCredit. That means the only way it could promote growth is if aggregate investment shifts toindustries that are less capital intensive. In other words, investment will move to sectorswhere there are more jobs per dollar of investment - but they will be service jobs. TheTreasury proposal is essentially a blueprint for the deindustrialization of America through thecreation of a service based economy.

By definition that will mean increased reliance on imports of manufactured goods as wellas the dislocation of thousands of Americans in manufacturing jobs. Such a vulnerable positionis totally inconsistent for a nation that claims the right to world economic and politicalleadership.

The irony, of course, is that this is industrial policy - of the worst sort. It does pickwinners and losers - and condemns an entire sector of our economy to the slag heap in theprocess. That the Administration apparently would do it accidentally rather than deliberatelyis cold comfort.

To make matters worse, our trading partners pursuing industrial policies deliberately aredoing the reverse.

A recent study by Arthur Anderson and Company compared the U.S. cost recoverysystem with the other leading industrial countries engaged in trade with the United States. Thestudy revealed that of the 16 nations studied, the U.S. ranks 8th in percentage of asset cost recovered during the first three years for machinery, equipment and industrial buildings. Luxemburg ranked first for all 8 years. Canada, however, for a 3 year period has one of thebest recovery systems. If Treasury's proposal to eliminate ITC and ACRS were successful itwould likely have the effect of persuading our manufacturing industries to locate in Canada.

What happens here if ITC and ACRS are eliminated? We would have higher taxes onmanufacturing and much lower taxes on sales. We would provide incentives for U.S. firms tolocate new facilities or expand existing ones abroad to manufacture goods for sale back into theU.S. Because of the relatively more favorable cost recovery allowances that are available inother countries, such as Canada, U.S. firms would manufacture abroad where they would payless tax on their "manufacturing" profit, and sell back into the U.S. at a reduced 33% tax rate on their "sales" profit.

Removal of these two foundation stones from our capital recovery system would act asa strong incentive to American businesses to increase investment overseas at a time when theyare already under

intense pressure to do so from the high value of the dollar in order to remaincompetitive with foreign producers. It is clearly a result that we cannot accept. That is whyI have urged Treasury Secretary Baker to revise his department's proposal.

It is clear that the continued pursuit of trade policies that ignore others' barriers and theexchange rate problems and tax policies that ignore the investment needs of our manufacturingsector can only contribute to our further deindustrialization and sustained movement towarda service based economy. While services and the jobs they provide are important, we shouldall understand that this shift is irreversible. If we give away our industrial base through benign neglect on the international front and passive tax policy domestically, we will never get it back. And with it will go our position of world leadership - first econmically and then just ascertainly, politcally.

Our situation reminds me of the priest and the rabbi who go to a prize fight together. As the boxers are about to go to the middle of the ring, the rabbi notices one of the boxerscrossing himself. Puzzled, he turns to the priest and says, "Father, what does that mean?" "Rabbi," said the Priest "it doesn't mean a thing if you can't fight."

This morning I invite all of you to join with me in learning both how to fight and toknow that fighting is essential - not just to win, but to survive.