

# **Congressional Testimony**

## **Testimony of**

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**to the**

**Senate Commerce, Science, and Transportation Committee**

**Hearing on the State of U.S. Manufacturing**

**“Blame Domestic Slowdown, not Trade,  
for Manufacturing Slump”**

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### **Introduction**

Chairman Hollings and other members of the Commerce Committee, thank you for inviting the Cato Institute to testify today on the state of U.S. manufacturing and the reasons behind the recent slump in manufacturing output. We can all agree that manufacturing is an important component of the U.S. economy and that the past three quarters have been an especially rough period for U.S. manufacturers. I suspect that the real debate lies in what has caused the slump, and what if anything Congress should do about it.

The temptation will be strong to blame foreign competition for the recent decline in manufacturing output, but that would be a serious mistake. In fact, U.S. manufacturing has prospered during much of the past decade, a period not only of rising manufacturing output but also of rising imports and growing trade deficits. The cause of the recent slump in output is not a flood of imports or a “giant sucking sound” of manufacturing investment moving overseas, but a slowdown in domestic demand.

Manufacturing has been hit by the same one-two punch of high interest rates and rising energy prices that has slowed output in the rest of the economy. The slowdown in domestic demand for manufactured goods, by consumers and by business, has caused inventories to accumulate and production to fall. Adding to the manufacturing sector’s pain

has been an appreciating dollar and sluggish growth in some important markets abroad. The problem for manufacturing has not been too much trade, but not enough domestic growth.

As members of the Commerce Committee consider the current state of U.S. manufacturing, please allow me to make four points:

### **Manufacturing Output Remains Near Record High**

First, the recent slowdown in manufacturing output should be seen in perspective. Up until the second half of 2000, the U.S. manufacturing sector was enjoying an almost-decade-long boom. According to the Federal Reserve Board, total manufacturing output rose by 55 percent between 1992 and September 2000. Domestic output of durable goods during that same period almost doubled. Output of motor vehicles and parts was up 75 percent; output of fabricated metal products, up 36 percent; output of industrial machinery and equipment, up 160 percent; output of electrical machinery, up almost 500 percent. This is not the profile of a nation that is losing its manufacturing base.

Since its peak last September, manufacturing output has declined every month, but total output remains almost 50 percent above what it was in 1992, and remains near its record peak of last year. Figure 1 shows the growth of U.S. industrial production--the total output of U.S. factories, mines, and utilities--during the past decade, and compares it to growth in other major industrialized countries. The chart illustrates a long stretch of uninterrupted growth in industrial output, growth that outpaced growth in the other major economies and our own growth of real GDP. Again, this hardly pictures a nation that is "deindustrializing."

### **Manufacturing Output and Imports Rise Together**

Second, the evidence is strong that imports have not been the cause of the recent slump in total manufacturing output. Until the recent slowdown, the economic expansion had been characterized by a simultaneous increase in the volume of imported goods and an increase in domestic manufacturing output. In fact, the growth of real goods imports and manufacturing output tend to be positively correlated. That is, as manufacturing output rises in the United States so too do imports of goods, adjusted for price changes.

The reason for this is simple. An expanding economy raises demand both for imports and for domestic production. Consumers with rising incomes buy more goods, both imported and domestically made. American producers also import more intermediate goods, such as auto parts and computer components, and capital goods. In fact, more than half of U.S. imported goods are not consumer products but are inputs and capital machinery for U.S. businesses. For example, steel imports help keep costs down for a wide swath of U.S. industry, including automobiles and light trucks, fabricated metal products, and construction.

As a result, imports tend to rise along with domestic output. Figure 2 shows the strong connection between manufacturing output and imports. It shows the growth in the volume of imported goods and manufacturing output for each year from 1989 through 2000. If the critics of trade were correct that rising imports have displaced domestic manufacturing output, we would expect manufacturing output to decline as the volume of imported goods rose. But since 1989, manufacturing output has generally expanded along with import volume, with output rising fastest during years in which the growth of real goods imports has also grown

fastest. As with so many other economic indicators, the same economic expansion that spurs manufacturing output also attracts more imports and enlarges the trade deficit.

In the last nine months, the trend has cut the opposite way: the 3.4 percent drop in manufacturing output since the second quarter of 2000 has been accompanied by a 3.2 percent drop in real imports of goods.

### **No Giant Sucking Sound**

Third, the recent slump in manufacturing cannot be blamed on an exodus of manufacturing investment to lower-cost producers such as Mexico and China. The giant sucking sound we were supposed to hear never happened. In the years after congressional approval of NAFTA and the Uruguay Round Agreements Act, domestic investment in the United States continued to climb, including investment in manufacturing.

The predicted flight of capital to countries with lower costs and standards never materialized. In fact, during the past decade the United States has been the world's largest recipient of foreign investment. Year after year the United States has run a net surplus in its capital account, with foreign savers investing more in the United States than American savers sent abroad. This inflow of foreign capital has kept interest rates down, built new factories, and brought new technology and production methods to our economy. If there has been any giant sucking sound since 1993, it has been the rush of global capital to the safe and profitable haven of the United States.

American manufacturers continue to be net investors in Mexico and China, but the relative magnitude of the investments remain small. From 1994 through 1998 the annual net outflow of FDI in manufacturing to Mexico averaged \$1.7 billion; the net annual outflow of manufacturing investment to China has been even smaller, averaging less than \$1 billion. Those sums are inconsequential in a U.S. economy that averaged almost \$8 trillion in annual GDP during the same period, and where annual domestic business investment exceeds \$1 trillion. In contrast to the relative trickle of outward investment to Mexico and China, domestic capital expenditures in U.S. manufacturing in 1998 totaled \$207.3 billion. In fact, in recent years, the United States has been a net recipient of billions of dollars in manufacturing FDI, much of it from Western Europe and Japan.

The American manufacturing FDI that does flow abroad generally flows to other high-wage, high-standard economies. According to a recent study on global manufacturing investment by the Deloitte and Touche consulting firm, other high-wage countries attracted 87 percent of total U.S. manufacturing FDI outflows in 1999, up from 75 percent in 1998 and 69 percent in 1997. The study explained, "Since only a relatively small percentage of a firm's costs are in wages, factors such as local market size, skill and education levels of the host country workforce, and political and economic stability become much more important for U.S. firms when making investment decisions."

The United States has nothing to fear from openness to trade and investment with less-developed countries. Global trade liberalization promotes investment, growth, and development in the United States as well as our trading partners.

### **Technology: The Great Job Displacer**

Fourth, it would be a mistake to focus on jobs rather than output as the measure of manufacturing health. Productivity gains in the manufacturing sector have consistently outpaced productivity gains in other sectors of the economy. We can produce more manufactured goods today with fewer workers because our manufacturing workers are so much more productive than they were in the past. If members of Congress are determined to stop any loss of jobs in the manufacturing sector, you would have to legislate not against imports, but against the capital investment and technological advances that are fueling the gains in manufacturing productivity.

Technology, not trade, is the great job displacer in the U.S. economy. In the last two decades, tens of thousands of telephone operators, secretaries, and bank tellers have been displaced from their jobs, not by imports, but by computerized switching, voice mail, and automatic teller machines. Further back in American history, entire industries have downsized or disappeared because of changing technology. Employment in the railroad industry plunged in the second half of this century because of competition from domestic airlines, automobiles, and trucks, not from foreign railroads. Employment in the agricultural sector fell steadily for decades, again not because of imports—America has long been a net exporter of food—but because of a mechanical revolution on the farm.

Recent employment data confirm that imports are not the major cause of job displacement. According to the Bureau of Labor Statistics, 7.5 million American workers age 20 and over were “displaced” from their jobs in 1997-99 because work was insufficient, the plant or company where they worked shut down or moved, or their position or shift was abolished. Of all the displaced workers counted by the BLS, 1.8 million, or less than one-quarter, were working in the manufacturing sector when they lost their jobs. The other three-quarters of displaced workers were in the essentially non-tradable wholesale and retail sectors or in other service industries at the time they lost their jobs. Those workers were displaced not by imports, but by new technologies and changing market conditions.

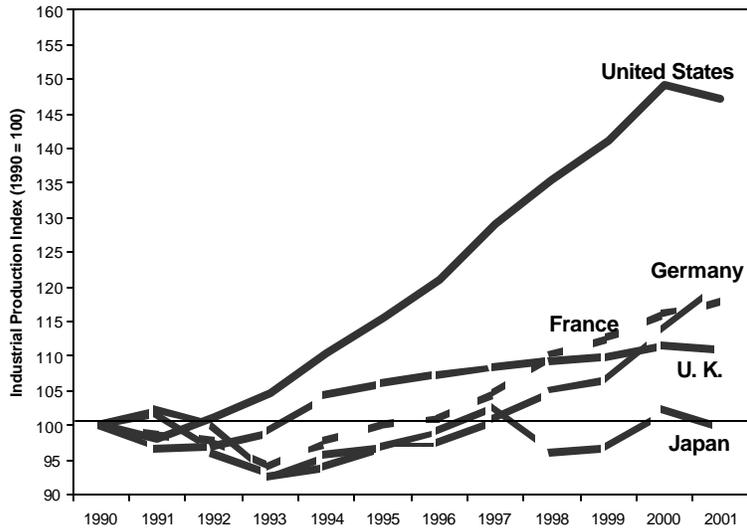
## **Conclusion**

In summary, the recent slump in manufacturing output is not the fault of rising imports or an outflow of capital, but of a slowdown in the domestic economy caused by high energy and borrowing costs. Manufacturing output boomed during much of the last decade during a time of steadily rising import volume and trade deficits.

An open and competitive U.S. economy has been a tonic for American industry. International competition has spurred innovation, efficiency, and customer satisfaction. The biggest winners have been American families, who benefit from the lower prices, greater variety, and higher quality of products that international competition makes available. Not all companies thrive in a competitive marketplace, of course, but for the health and vitality of the American manufacturing sector as a whole, not to mention the overall economy, international trade has been a blessing.

Figure 1

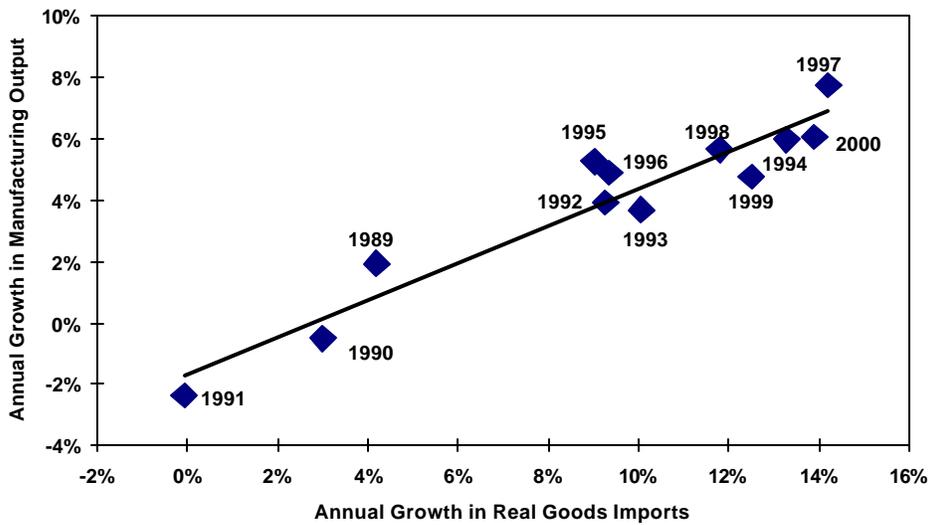
### America's Industrial Expansion, 1990-2001



Source: Joint Economic Committee, *Economic Indicators*, May 2001, p. 35.

Figure 2

### Goods Imports and Manufacturing Output Grow Together



Sources: U.S. Department of Commerce, Bureau of Economic Analysis, <http://www.bea.doc.gov/bea/dn/nipaweb/TableViewFixed.asp>;  
U.S. Federal Reserve System, <http://www.federalreserve.gov/releases/G17/ipdisk/ip.sa>.