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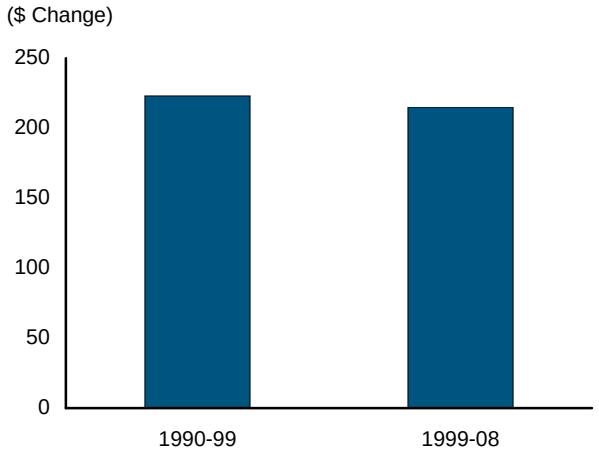
US Economic and Investment Perspectives

US Manufacturing Trade Deficit Needs Attention from Policymakers

Over the past nine years, the non-oil manufactured trade deficit in the US widened by $215 billion, a little less than the gap that developed over a similar time span in the 1990s (**Display 1**). But the causes of the deterioration are fundamentally different and must be understood before policymakers make decisions that could hurt the competitive positions of US companies.

Display 1: Different Factors Drove Trade Gaps

$ Change in US Non-Oil Manufactured Goods Trade Deficit

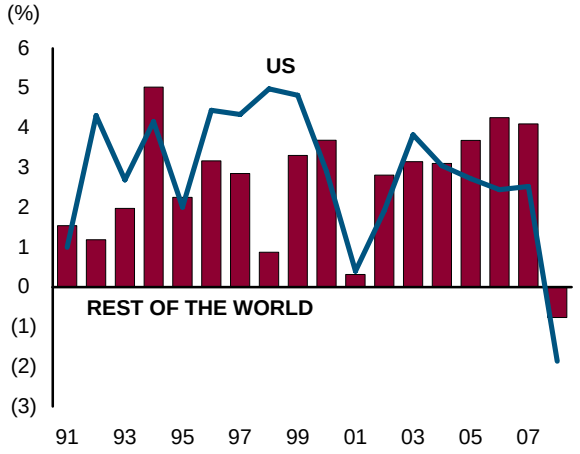


Source: Census Bureau, Haver Analytics and AllianceBernstein

In the 1990s, the widening trade imbalance was largely the result of a relative shift in the pace of economic growth. At the time, US real GDP was increasing by an average annual rate of 3.6%—nearly 1.25 percentage points faster than the global average excluding the US (**Display 2**). The relatively strong cyclical performance led imports of non-oil manufactured goods to more than double, far outstripping the 70% gain in exports and triggering a steady and sustained widening in the manufactured goods trade deficit.

Display 2: Strong Growth Fueled 1990s Deficit

Real GDP Growth: US vs. Rest of the World



Source: Bureau of Economic Analysis, Haver Analytics and AllianceBernstein

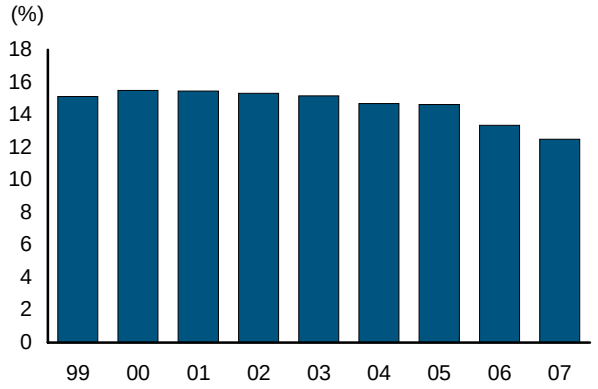
The deterioration in the US non-oil manufacturing trade balance since 1999 is a completely different story. During the last decade, US growth has slowed to about 2% per year, almost half as fast as before, while underperforming the global average by roughly 0.75 of a percentage point. In our view, the catalyst for the widening deficit in recent years has been a historic supply shift, in which imports of manufactured goods have replaced domestically produced goods en masse.

Domestic Production Squeezed out of US

Press reports suggest that this trend has been driven by US manufacturers moving production offshore and then importing similar goods and materials from affiliates abroad to supplant products that had previously been produced at domestic facilities. We don't think that this popular explanation is accurate. Although it's true that imports by US multinationals from foreign affiliates increased over the last decade, these companies' share of non-oil manufactured imports dropped from 15% in 1999 to 12.5% in 2007 (**Display 3**, next page). In our view, this indicates that most of the import growth has been coming from foreign producers, and domestic production has been squeezed out in the process.

Display 3: US Relies Less on Offshore Affiliates

US Multinational Imports from Affiliates as % of Total Non-Oil Manufactured Imports



Source: Bureau of Economic Analysis, Haver Analytics and AllianceBernstein

The deterioration of recent years is fundamentally more threatening to the US economy than the deficits of the 1990s. Widening trade gaps caused by a sharp divergence in growth can be corrected by a shift in global policies. For example, the US could adopt a tighter monetary policy to slow demand (and reduce imports), while key trading partners could adopt a more expansionary policy mix to spur demand (and boost imports). Similarly, a weaker US dollar, which should naturally flow from a wider deficit, could add to the adjustment process as it alters import and export prices.

However, trade deterioration caused by a shift in supply is much harder to eradicate, as it may be the result of a weakening competitive position that will eventually lead to a closure of manufacturing operations. Without sufficient manufacturing scale, the US will struggle to benefit from a substantial change in the terms of trade, such as a weakening of the dollar that would make US exports more competitive on world markets.

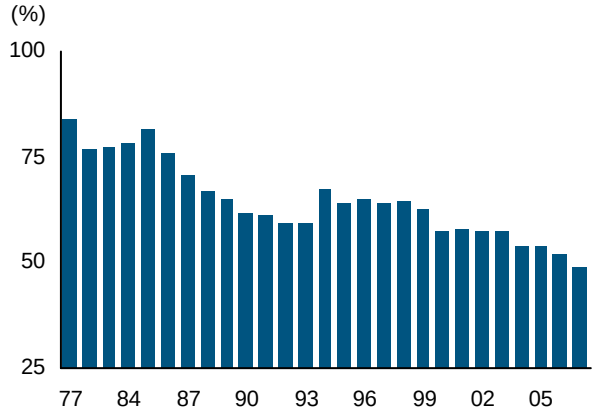
In our view, policymakers must be aware of these issues as they consider important legislation on energy, climate change and healthcare. Recently, a group of 10 Democratic senators sent a letter to President Obama objecting to any measure on climate change that could hurt the competitive position of US industries. It would be "self defeating," they argued, to pass legislation that helps to eliminate greenhouse gas emissions and improves the environment but hurts US competitiveness and destroys jobs in the process.

Productivity and Investment Are Crucial

Studies have shown that plant closings tend be highest in industries that face competition from low-wage countries, especially if they are owned by US multinational companies that have the option of shifting production abroad. Given the huge cost disadvantages the US faces in some labor-intensive industries, it is unlikely that supply in these industries will shift back in favor of the US. The US must therefore concentrate on promoting higher value-added and more capital-intensive industries.

Display 4: Record Low Share of Exports by Large Firms

US Multinational Exports as % of Total Exports



Source: Bureau of Economic Analysis and AllianceBernstein

Efforts to raise manufacturing productivity have been very successful in the past, and some of the biggest gains have been recorded in industries that are the biggest US exporters. Yet despite these gains, the export share of US multinational companies dropped below the 50% mark in 2007 for the first time on record, according to a new report by the Bureau of Economic Analysis (**Display 4**). Perhaps the shift towards greater domestic demand growth in many emerging markets and a more competitive dollar will make the US a larger export hub. But we believe that in order to properly repair the trade balance, the US must do more to encourage new capital, investment and products from existing and new companies.

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