Oral Testimony of Mark Zandi
Chief Economist and Co-Founder of Moody's Economy.com

Before the Economic Policy Subcommittee of the Senate Banking Committee

"The U.S. as Global Competitor: What Are the Elements of a National Manufacturing Strategy?"

July 17, 2009

Mr. Chairman and members of the committee, thank you for the opportunity to testify on such an important matter in a time of economic and financial crisis. I am an employee of the Moody's Corporation, but my remarks today reflect my personal views.

I will make eight quick points in my remarks this morning:

1) The economic crisis continues, and aside from housing, manufacturing has suffered more during this period than any other sector of the economy. The statistics are grim. Industrial production has fallen over 17% since peaking a year and a half ago, capacity utilization is at a record low, manufacturing capacity is falling, and close to 80% of manufacturing industries are suffering consistent declines in manufacturing production and employment. Manufacturing's problems began long before the current recession. Industrial production has actually declined during this decade. This is the worst performance on record. Even during the decade of the 1930s' Great Depression, production eked out a small gain. Manufacturing employment has been declining even more sharply, losing more than 5 million jobs this decade. The less than 12 million currently employed in manufacturing—accounting for less than 10% of total payroll employment—is the lowest level since just prior to World War II.

2) The unprecedented decline in manufacturing during this downturn is the result of the collapse of the vehicle and housing industries, a deep recession throughout the global economy, and draconian cuts by U.S. businesses in their investment in technology and other equipment. The longer-running decline in U.S. manufacturing is largely due to the loss of market share to global competitors; since the turn of this decade, most of the decline in market share has been to Chinese manufacturers.

3) Manufacturing has played an outsized role in economy-wide recessions and supporting growth early during economic recoveries. Real GDP has fallen by an average of 2% peak to trough during recessions since World War II, with manufacturing contributing well over one-half of the decline. In the first year of recovery, manufacturing has been responsible for over one-fifth of the growth in GDP. In the first year after the recession in 2001, manufacturing accounted for almost one-half of total GDP growth. Manufacturing's large role in the ups and downs in the business cycle results from the impact of large inventory swings and the high interest-rate sensitivity of many manufacturing industries.

4) Manufacturing will not be able to contribute as much to the economy's growth in the recovery from the current downturn. The problems in the vehicle and housing industries will not abate quickly. Vehicle sales and production and housing construction will rise from their currently extraordinarily depressed levels in the next 12 to 24 months, but only very modestly. Weighing on vehicle sales and production will be the lingering effects of the GM and Chrysler bankruptcies and the spent-up demand created by sales levels above those that could be supported by underlying demographic, wealth and income trends during the strong sales years earlier in the decade. Housing construction and thus the demand for manufactured construction supplies will also be constrained by the large amount of excess housing inventory built up during the housing boom and bubble.

5) Manufacturing's importance to the broader economy goes beyond its share of GDP and employment. It is vital to national defense, lower- and middle-income households that rely on manufacturing's relatively high-paying jobs, and many smaller metro area and rural communities across the nation in which the factory is one of the largest employers. Manufacturing is also important to research and development, innovation, and ultimately the economy's productivity growth and the growth in the nation's living standards. It is also important to note that manufacturing will need to play a more important role in the nation's longer-term economic growth, as the most significant growth opportunity for U.S. businesses lies in selling to customers overseas. U.S. manufactured goods must be a large part of what we sell to them.

6) There are number of things policymakers should and should not do to address the manufacturing downturn. The most obvious thing policymakers should not do is to erect trade barriers to limit trade in manufactured goods. This would be very counterproductive, particularly at this time, when the global economy is in recession and protectionist sentiment is building nearly everywhere. A trade war could very well ensue, derailing prospects for recovery here and elsewhere. However, policymakers should work to guide the Chinese to continue revaluing the yuan once global financial and economic conditions stabilize. The yuan has appreciated by 17% since the revaluation process began four years ago, but the currency remains 20% to 25% overvalued against the dollar. This gives Chinese manufacturers an unfair competitive advantage in global markets.

7) Policymakers should implement policies that reduce the costs of doing business for manufacturers. To lower the cost of labor, policymakers could invest in technical schools and community colleges, facilitate work share programs to reduce the cost of unemployment insurance and worker layoffs, and more aggressively establish and fund worker retraining efforts. Healthcare reform that results in slower growth in healthcare costs is also very important. To lower the cost of capital, policymakers could establish a direct lending program at the SBA and perhaps even establish lending facilities to help finance investment in clean energy and other technologies. To lower the cost of transportation, telecommunications and energy, policymakers could provide consistent support to public investment in transportation networks, the internet backbone, and the electric grid. As a potential example of this support, Build America bonds issued as part of the current fiscal stimulus have been very successful.

8) Industrial policies directed to specific manufacturing industries have not been successful in stemming the long-running decline of these industries. To be sure, there has not been extensive historical experience with such policies here in the U.S., but what experience we do have and what we have learned from the experience of other developed economies suggest that such targeted industrial policies are not productive. A much more efficacious policy effort is to facilitate lowering the costs of production and opening global markets for all businesses, with special attention to and consideration of those costs and markets generally most important to manufacturers.

In conclusion, the severe slide in the nation's manufacturing base will constrain the ability of the overall economy to rebound from the current Great Recession. It also jeopardizes the financial prospects of many lower- and middle-income households, the economic well-being of many communities across the country, and even the innovation and technological progress necessary to power the broader economy's long-term growth. Policymakers should carefully consider this when designing and implementing economic policy.