

# no. 1187

Special Report

# The Reindustrialization of the United States



Euler Hermes Economic Research Department

# Economic Outlook

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## Editorial

# An alignment of the stars?

With the post-presidential election fever now gone, the immediate shift of the U.S. focus is squarely on the economy. Surely, the road to recovery looks like the Labors of Hercules. Of course no economic environment will ever be perfect, but the current uncertainty surrounding the fiscal cliff and the ongoing debt crisis in Europe are the two largest headwinds currently affecting the U.S. economy. Beyond the tumult in the short run, there are some positive macro- and micro-economic factors that have caused us to look more thoroughly to what the 'new normal' could look like for the U.S. Here begins a quest to better understand what underlying trends and dramatic regime changes may support a robust long-term growth in the U.S. The potential key to America's long-term growth lies in the very heart of the country, its manufacturing sector. Bullied throughout the last decade, its resilience and malleability, further tested by the most too recent crisis, may actually demonstrate why it now appears to be the backbone of the U.S. recovery. There are several determinants to this bold assumption which we analyze in this report:

- > unit labor costs are among the lowest in the industrialized world;
- > energy costs are low thanks to the gas bonanza;
- > the cost of capital is very low given the Fed's ultra-accommodative monetary policy;
- > the weak dollar makes U.S. exports very competitive in the majority of U.S. export markets; and
- > the housing market is slowly rebounding.

If you add to this a conducive policy environment and the definite commitment to continue to improve it, there are better days ahead for the U.S. and its private sector. After the perfect storm (the commodity, financial and jobs crises), now would be the time for an alignment of the stars. Manufacturing could lead the U.S. economy out of recession, and is poised to be a major contributor going forward.

What needs to be done to maintain the momentum? The private sector in the U.S. continues to be relatively self-reinventing without much intervention. But like a good gardener, the government may want to occasionally water the flowers. In this report, we outline several actions necessary to catalyze this rebirth.

Of course, we will continue to monitor this reindustrialization phenomenon and accompany our clients on the still bumpy road ahead. It is all about good 'ol production, key industries such as the energy and chemicals sector and the agri-food businesses, and growth markets: the South, Texas, and California. If supported, the real economy should indeed regain its strength. *—Ludovic Subran*

A large industrial crane is lifting a massive, dark, cylindrical component, likely a ship's hull section, at a shipyard. The crane is positioned on the right side of the frame, with its long boom extending over the component. The component is suspended by several thick cables. The background shows a cloudy sky and other industrial structures. The image is overlaid with a semi-transparent red filter on the left and right sides.

## Overview

# Like a Phoenix Rising from the Ashes

## A turning point?

Ever since the Industrial Revolution began in the 1800s, the U.S. manufacturing sector has always been of vital economic importance. It has often been the engine of growth, historically providing strong contributions to Gross Domestic Product (GDP). During the nineteenth and twentieth centuries economic industrial concentrations developed across the U.S. In the South, proximity to cotton growers helped build the textile industry. From the Northeast to the central Midwest, steel and iron products emerged and as a result the automobile industry arose in the Midwest. In the Southwest, an abundance of oil and natural gas shaped the energy industry. And in the West, high technology emerged during and after WWII as a product of the defense industry.

However this robust manufacturing economy came under intense pressures in the latter half of the twentieth century from the development of the global economy. Countries such as Japan, Mexico and China emerged with enormous supplies of people who were willing to work for a fraction of U.S. wages, while concurrently, American consumers developed a thirst for inexpensive goods from overseas. American businesses could not resist the lure of much lower manufacturing costs available in these countries and began to send U.S. jobs overseas, decimating many industries such as appliances, furniture, heavy equipment, shipbuilding, steel, textiles, and many others. As a result of this shift, the U.S. manufacturing industry shrank drastically as a percentage of the entire

economy and millions of manufacturing jobs were lost.

But this trend is now on the cusp of reversal for several reasons. U.S. manufacturing productivity has grown at a relatively high rate compared to other industrialized nations, making U.S. unit labor costs the lowest in the industrialized world. Highly skilled American workers can more reliably produce higher value-added goods. Costs such as transportation, inventory and lag time are lower while tax incentives and cheap energy make manufacturing in the U.S. even more attractive.

As a result, U.S. manufacturing is enjoying a renaissance and recently led the country out of the most severe recession since the Great Depression, contributing much more to GDP growth than one would expect given its weight in the economy. In fact, after the recession, the only job growth outside the services sector was in manufacturing. Of course the outlook is brighter for some industries and regions than it is for others, but the business environment suggests that conditions going forward will continue to be favorable, even in a world of uncertainty.

tions all around the world. The incidents highlighted how dangerous exposure to foreign supply chains could be and how a lack of preparedness for these risks causes difficulty in implementing risk management protocols for what were previously thought to be unthinkable events.

Going forward, and when examining specific U.S. industry dynamics, it seems important to selectively support:

> The “shining” industries mentioned above, in order to identify more specifically the growing sub-sectors (agriculture, construction/mining, machinery, medical equipment, petroleum-related products, semiconductor-related products) and examine their dynamics. The automotive sector also seems to be reviving from its ashes;

> A conducive business climate with a clear emphasis on innovation. The new era in the business environment (tightening gap between Chinese and American wages, appreciation of the yuan, access to cheap energy in the U.S., structural high oil prices, mounting awareness of the vulnerability caused by an over-stretched supply chain) could help U.S. manufacturing sustain this momentum. U.S. computer/electronic product manufacturing, machinery, furniture and miscellaneous product manufacturing are expected to take advantage of the falling Chinese wage competitiveness. Chemicals and primary metal sectors should gain ground thanks to cheap shale gas; and

> Regional strengths make the efficient specialization of the individual states feasible. The dynamics in the South, Texas, and California - particularly with niche sectors, incentives, and opportunities - are particularly important as they appear to be the renewed growth centers of the U.S.

This degree of industrial investment demands that the U.S. economy present sound, reliable growth prospects and that the financial system (banks and bond markets) support these capital intensive projects. It also requires a confidence injection for the private sector to continue to re-shore and invest in the economy. Finally, the path to industrial rebirth will require a highly skilled workforce. ■

## Short-lived effect or durable trends?

**B**eyond positive macroeconomic factors such as credit availability and low interest rates, the three determinants of this reindustrialization are:

> lower labor costs, especially in the southern States;

> lower cost of energy resulting from the shale gas bonanza; and

> the ability to steer the economic environment to leverage the positive cost reductions from which companies have been benefitting.

Another factor is the new awareness of operating vulnerability created by an over-stretched supply chain. In 2011, the localized production disruptions in Japan following an earthquake and a tsunami, and in Thailand from flooding, disrupted industrial opera-

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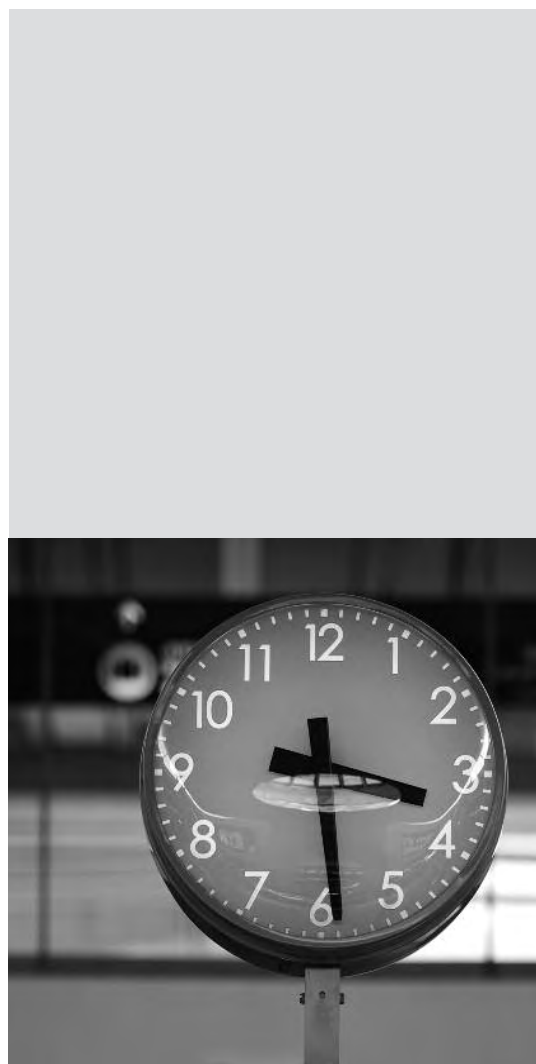
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