BARRON'S Online

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Will U.S. Manufacturing Go to Zero?

By DIMITRA DEFOTIS

FOR A GLIMPSE OF THE FUTURE of U.S. manufacturing, look no further than the corn and wheat fields of the American heartland.

Representing half the nation's economic output before the Civil War, agricultural production still accounted for nearly 10% of gross domestic product at the end of World War II.

Fast forward to 2003, when combines with computerized fertilizing schedules do what scores of family farmers once did, and agriculture comprises less than 2% of GDP.

Could manufacturing go the same route?

Since 2000, more than two million U.S. manufacturing jobs have been eliminated or moved overseas. Manufacturing's role in the economy has dropped from nearly 30% of GDP after the war to only 14% in 2002.

How much further could it fall?

"In the case of a country like the United States, it could get to zero," states Barry Bosworth, an economist and senior fellow at the Brookings Institution in Washington, D.C.

"The long-term trend is [that] the role of manufacturing declines for high-income countries. This has been happening for a long time and will continue."

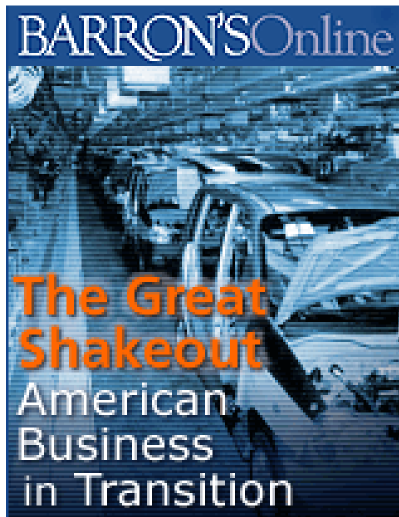
There were 14.7 million jobs in U.S. manufacturing in May, and the U.S. Department of Labor is in the process of revising (likely downward) its projection that manufacturing jobs will show weaker than average total growth of 3.1% by 2010. But some job categories, like tool and die makers or industrial engineers, could see almost no growth during that time.

With the force of a steam locomotive, technological progress and globalization are pushing the manufacturing sector and the entire U.S. economy into a new period of change perhaps unrivaled since the Industrial Revolution. Price competition, overcapacity and investors' demands for more higher profits are pressuring U.S. corporations to squeeze every last dollar of "excess" cost out of their operations.

This trend has been going on for some time -- U.S. productivity surged 38% from 1994 to 2002 -- as companies consolidated and used new technologies to increase their efficiency. But now, the liberalization of world trade and the emergence of nations like China, India and Mexico as centers of manufacturing and

technology for U.S. firms is only speeding up the transition.

This week, Barron's Online departs from our usual Weekday Trader format to concentrate exclusively on this tectonic shift in the economy, which we call "The Great Shakeout." In today's installment, we examine changes in manufacturing. We'll look at services on Tuesday and technology on Wednesday, and on Thursday we'll focus on some of the economic and political implications of these changes.



To some degree, manufacturers are in the vanguard of this change: For years, they've been forced to cut costs in the face of growing commoditization of their products and chronic overcapacity. One strategy they've adopted: consolidation. In industries from chemicals to paper, merger after merger has slashed expenses while reducing competition.

"If a company can absorb others' capacity efficiently, it can expand margins," says William Dierker, a manager of the One Group Large Cap Value Fund.

For instance, tool maker Danaher (whose stock his fund owns) added $800 million in revenue through acquisitions last year, while Ingersoll-Rand, which makes construction and refrigeration equipment, has been steadily cutting costs while buying more profitable businesses.

And there is room for even more consolidation, says Holden Lewis, an analyst at BB&T Capital Markets.

In March, for example, Timken, which produces engineered bearings and alloyed steels, completed its acquisition of Torrington, a smaller maker of bearings and other components. That should help Timken increase its peak earnings power as it lowers its cost of capital, Lewis says.

Timken was part of another, sweeping movement -- outsourcing production overseas. In Timken's case, it opened ventures in Eastern Europe and China, which has become the industrialized world's workshop (or sweatshop, some critics charge).

More and more manufacturers have relocated operations to countries where labor costs are much cheaper. That's been happening for a long time in industries as diverse as semiconductors, shoes, clothing, toys and furniture. But the outflow of jobs now reaches sectors like industrial machinery and computer technology, too.

Who's next? Service jobs within manufacturing companies. According to Forrester Research, roughly a third of the 3.3 million service jobs expected to move overseas by 2015 will be in manufacturing, as back-office positions like customer service and technology help desks head to countries like India.

The dollar's recent weakness may slow that exodus somewhat, says Gerald D. Cohen, a senior economist at Merrill Lynch. But manufacturing is wide open to global competition.

And that's a good thing, he adds, because competition ultimately improves quality. He points to American competition with Japanese automakers in the 1980s that yielded better cars. Now, he says, Japanese companies manufacture some cars in the U.S. because "our workforce is more efficient and may be [even] lower paid adjusting for currencies."

U.S. companies will have to work hard to continue making cars and computers efficiently here at home -- although Cohen thinks productivity gains and a skilled labor force will keep high-end manufacturing and research and development operations here.

"We may not make the chips here, but do the R&D and make the machines that make the chips," he says.

"One hundred years ago, you measured output in tons of iron, steel or coal," says Jay Mueller, economist and director of fixed income at Strong Capital Management in Wisconsin. "The natural progression of the economy [is] goods with high intellectual content are likely to do better than those that are pretty much commodity products."

"My theory is U.S. manufacturing will continue to exist and will probably tend to migrate further up the value chain," he says.

That's why Bosworth of the Brookings Institution thinks that manufacturing jobs in fields that require high intellectual input, like supercomputing or medical technology, are the ones most likely to survive.

One possible exception: the Defense Department will probably continue supporting a large domestic manufacturing presence in the aerospace and defense industries, for national security reasons. That should benefit companies like Boeing, whose defense business is growing but whose commercial-aircraft business has been losing market share to the heavily subsidized Airbus consortium.

Meanwhile, the AFL-CIO is pushing for monetary and policy changes that will protect manufacturing jobs, which advocates say create more jobs than service industries do, thereby bolstering overall economic growth. But Bosworth thinks protecting jobs is inefficient when retrained workers can instead move to new, better-paying jobs.

"It can be painful when you throw people in their 40s and 50s out of work or you close a plant in a small town," Bosworth says. "But in the long run, our future does not lie in the increase in manufacturing jobs."

As U.S. manufacturers face a Darwinian struggle in an increasingly competitive world, they're bound by only one immutable rule: make a profit -- and investors are demanding more and more of those every year.

That, along with the natural evolution of the U.S. economy and the rapid development of other parts of the world, are pushing U.S. manufacturers to consolidate and outsource even more and, whether they want to or not, move up the value chain.

Like evolution itself, these changes have the force of natural law: They're all about survival, and for U.S. manufacturers there's just no turning back.

Tuesday: The Great Shakeout -- Will services go the way of manufacturing?

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BARRON'S Online

Tuesday, June 24, 2003

Will Services Go Manufacturing's Way?

By ALLISON KRAMPF

Editor's Note: On Monday Weekday Trader examined how consolidation and outsourcing were transforming the manufacturing economy. In today's installment of our series, The Great Shakeout, we look at how they're affecting service businesses.

FOR YEARS, MANUFACTURING BORE the brunt of companies' efforts to control costs in their efforts to be competitive.

Now, it's the service sector's turn.

Amid a weak global economy and intense pressures from investors to boost shareholder returns, service businesses, too, have been merging and are shipping jobs overseas to boost profits by slashing costs even further.

These trends have been going on for some time, but as in manufacturing, they may pick up speed in what is shaping up as a major restructuring of corporate America.

In the service sector, which represents about 55% of the U.S. gross domestic product, "further consolidations are likely, to take advantage of cost [savings] and build economies of scale," says Ron Masulis, professor of finance at Vanderbilt University's Owen Graduate School of Management. He expects that trend to continue for some time.

And over the next 15 years, 3.3 million U.S. service industry jobs and as much as $136 billion in service-business wages will move offshore to countries like India, Russia, China and the Philippines, according to Forrester Research.

The economics behind it is almost a no-brainer: This kind of outsourcing can cut costs dramatically, the Forrester study says.

Any function that involves the gathering and re-keying of information can be taken offshore, where "you can get the equivalent of a Certified Public Accountant (CPA) for half the price" of an American one, says John McCarthy, Forrester's group director of research.

The information-technology industry should continue to lead the exodus, although back-office accounting, software and product development and customer service and call-center activities in health care and insurance are most likely to be shipped out to cheaper offshore locations, Forrester says.

Nowhere are these trends more evident than in financial services. Some financial services companies, such as mutual fund firms, have been longstanding users of offshore and outsourcing. But now, the rest of the group is joining the party.

"We are not aware of any major U.S. financial institution not exploring offshoring at this point," says Peter Lowes, a partner with Deloitte Consulting. **HSBC** and **GE Capital** already are implementing outsourcing programs.

Behind these moves is the lack of pricing power in financial services, where customers seem unwilling to pay up for "me-too" products that they perceive to have little added value.

"The entire financial services business is getting commoditized," says Dushyant Shahrawat, senior analyst with The Tower Group. "There is a need to cut expenses to get the profit line up."

So, it's not surprising that some 500,000 financial services jobs will be relocated offshore within the next five years, according to consulting firm A.T. Kearney. That represents 8% of the industry's U.S. workforce, and could result in $30 billion in annual cost savings for financial services companies.

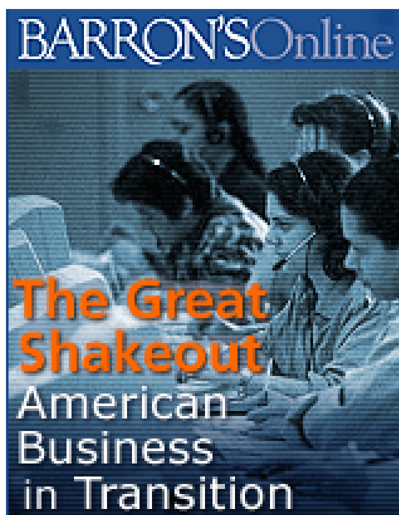
In fact, the amount North American brokerages will spend on offshore contracts should triple to $1.31 billion in 2005, from $417 million last year.

Finance companies are increasingly taking advantage of the educated workforce in India, which produces about as many college graduates as the U.S. does and where talented, English-speaking labor comes cheap. (They're also looking to farm out work to other emerging markets such as South Africa, the Philippines, Costa Rica and Mexico.)

Finance specialists in areas such as equity research earn an average of $1,000 per month in India, compared with the U.S. average of $7,000 per month.

"Higher-end service-type jobs are being migrated," and that includes research and financial analytics, says Andrea Bierce, vice president at A.T. Kearney, an author of that firm's report on outsourcing in financial services.

J.P. Morgan Chase, for example, expects to hire 40 junior research analysts and 1,000 other support staffers this year in Bombay, according to Reuters. Those analysts could earn bonuses one-quarter of what their counterparts get in New York or London, the news service reported.



In fact, says Bierce, "financial institutions have had to cut so many people they are concerned with how they will quickly respond to a business pick-up." So, they are setting up their own call centers or processing venues offshore rather than outsource to third parties. The result, however, is ultimately the same: more financial services jobs overseas, fewer of them here.

Mortgage servicing, too, seems ripe for the cost savings outsourcing and consolidation yield.

"The mortgage industry is highly competitive. There are about 7,500 companies that fund mortgage loans, and any savings or efficiencies can get passed back to the consumer immediately in better pricing," says Doug Duncan, chief economist with the Mortgage Bankers Association of America.

Duncan notes that several companies could use one outsourcer, rather than having each one set up its own operations overseas. "A small company servicing 50,000 loans could have a

$3.00 per-unit cost, but if one outsourcer does that for ten companies servicing 500,000 loans, the combined volume may be done for only $2.50 per call," he points out.

Meanwhile, on Wall Street, weak retail and investment banking business has sparked speculation (from people like Morgan Stanley's chief executive officer, Philip Purcell) that we could be on the verge of another round of consolidation -- driven by the need for greater economies of scale.

"There may be the temptation in investment banking to merge, since profits have not been so great," says Masulis, mentioning a couple of the usual suspects as possible targets -- **Bear Stearns** and **Lehman Brothers**, both of whose stocks have been on a tear since late last year.

Of course, that would depend on the would-be acquirers' willingness to pay steep prices for their rivals, which is why a new Wall Street merger wave could be several years away.

Traditional banking, however, remains ripe for further consolidation, since there is still too much capacity in the domestic banking system, says Jason Goldberg, bank analyst with Lehman Brothers.

"Everyone right now is focused on 'de novo' expansion.," says Goldberg. (*Editor's Note: 'De novo' expansion is banking industry jargon for building new branches and facilities.*)

"But clearly, with 9,000 U.S. banks, consolidation has to pick up" at some point, he adds.

The U.S. had more than 15,000 banks in 1990, and Vanderbilt's Masulis estimates that there could be only 4,500 banks left within the next five years -- driven once again by the need for cost savings and economies of scale.

Banks that have historically been acquirers, such as **Wells Fargo**, **Fifth Third Bank** and **Wachovia**, are likely to continue to do so.

And foreign banks, which have paid hefty premiums for U.S. firms, could again look to buy their way into the U.S. market. They could include **Royal Bank of Canada**, Royal Bank of Scotland and **BNP Paribas**, Goldberg says.

U.S. financial services companies that do outsourcing may have the advantage over their European counterparts, who would face strong union resistance if they tried to shift too many well-paying jobs from Europeans to lower-wage workers in other countries, Shahrawat says.

So, although more American workers may lose their jobs in the short run, American companies and the U.S. economy will be more competitive over the long haul.

Because it all boils down to competition and shareholders' return, and large services companies can go anywhere in the world to find skilled workers to do the job. Isn't that what globalization is supposed to be all about?

Wednesday: Will Tech Still Be a Growth Engine?

June 23: The Great Shakeout, Part I: Will U.S. Manufacturing Go to Zero?[1]

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