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U.S. NEEDS MORE INVESTMENT TO REDUCE EXTERNAL DEFICIT

December 10, 2004

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U.S. Economic and Investment Perspectives

U.S. Needs More Investment to Reduce External Deficit

For months now, the burgeoning U.S. current account deficit has been the source of much concern to global policymakers and the financial markets. It's easy to understand why: This year, it is expected to exceed $600 billion, or nearly 6% of GDP. A current account deficit occurs when a country's consumption and investment exceeds its domestic savings and overseas investors step in as lenders to sustain its economic growth. Put another way, the U.S. now consumes more than it produces. And the foreign investors who are financing the country's deficit are racking up an alarming claim on our nation's capital assets.

Many critics believe the panacea is to promote policies aimed at encouraging greater domestic savings and suppressing consumer and government spending. While this would clearly help, we believe such a solution to be overly simplistic because it fails to address the root of the problem.

Fundamentally, the U.S. lacks the industrial base to correct its trade imbalance. According to the Bureau of Census, roughly 25,000 manufacturing plants have been shuttered since 1998, and in recent years, because of weak market conditions, manufacturing companies have cut back on plant and equipment spending. This has made the physical capacity problem even more acute: The net capital stock of the manufacturing sector, expressed as a percent of total private fixed assets, has dropped from around 8% in 1998 to less than 7% in 2003, a record low (**Display 1**).

The lack of investment in new capacity and new products has meant that more of the incremental demand for goods purchased in the U.S. has been supplied by foreign producers. Our analysis shows that imports have accounted for roughly 60% of the incremental increase in the purchases of consumer and business goods since 1998 (**Display 2**). This clearly indicates that the current account imbalance reflects the lack of an adequate U.S. industrial infrastructure; in order to redress the imbalance, the U.S. must attract higher levels of investment from both domestic and foreign firms. The U.S. is well positioned to do so for several reasons.

First of all, we estimate that U.S. corporations have generated free cash flow—the difference between net cash flow and business spending on equipment and software—of roughly $1 trillion in the past three years. Measured in relation to business spending on equipment and software, this represents the biggest war chest of free cash since the early 1960s (**Display 3**). Not surprisingly, the surge in free cash in the early 1960s ushered a huge wave of new investments that lasted for several years. A similar scenario seems to be unfolding today. A Business Roundtable December 2004 survey found that half of the CEOs surveyed expect to increase capital spending and remain upbeat about business conditions for early 2005.

Second, the decline of the dollar since 2002 has made U.S. products more competitive. The real value of the U.S. currency has declined roughly 25% against a basket of major currencies and 18% against a broader basket. The benefits are appearing in improved sales, production and profits. U.S. exports of merchandise goods are running 10% ahead of year-ago levels, the best performance since 2000. At the same time, U.S. manufacturing production is running 6% over year-ago levels, the fastest in several years and the fastest among G7 countries.

Third, the depreciation of the dollar and the strong possibility of protracted currency weakness should, in time, trigger a strong rebound in foreign direct investment (FDI) in the U.S. It really doesn't matter what the motivation of foreign investors is—whether to protect market share or to establish a foothold in the world's biggest market. What matters most is the decision to invest again in the U.S. The benefits of FDI are substantial. It's been pivotal in moving plants around the world and has been far more important than foreign trade in improving productivity, transferring technology and creating jobs. It would also create a much more stable source of current account financing than the current concentration in U.S. Treasuries and agency debt, as FDI represents a long-term commitment.

FDI has been very weak in recent years (**Display 4**), following several years of very strong gains. The surge in FDI in the late 1990s reflected a sharp increase in overall merger-and-acquisition activity in the U.S. At that time, foreigners were eager to gain access to the advanced and growing technological capabilities of U.S. business, and to take advantage of the economies of scale in engineering, purchasing, manufacturing and distribution. In recent years, however, FDI flows have plummeted, reflecting lackluster returns in the financial markets and the perception by overseas investors that U.S. assets were overpriced.

Today, we think the economic and financial conditions are very attractive and that it's only a matter of time before FDI flows rebound sharply. A very strong profit cycle, for instance, has resulted in more reasonable valuations in the financial markets. And given the sharp fall in the dollar, U.S. assets look even more attractive on a foreign-currency basis. History suggests that capital will flow to a country that is welcoming and offers attractive returns. From our vantage point, the pendulum is swinging in favor of a sharp pickup in FDI flows toward the U.S. over the next several years.

The outlook for economic growth in 2005 and beyond hinges largely on anticipated gains in external trade and capital spending. The U.S. is currently enjoying a rare combination of ample domestic liquidity, strong corporate free cash flow and a competitive dollar. We believe this powerful alliance could in 2005 push U.S. GDP growth well above current expectations of 4%.

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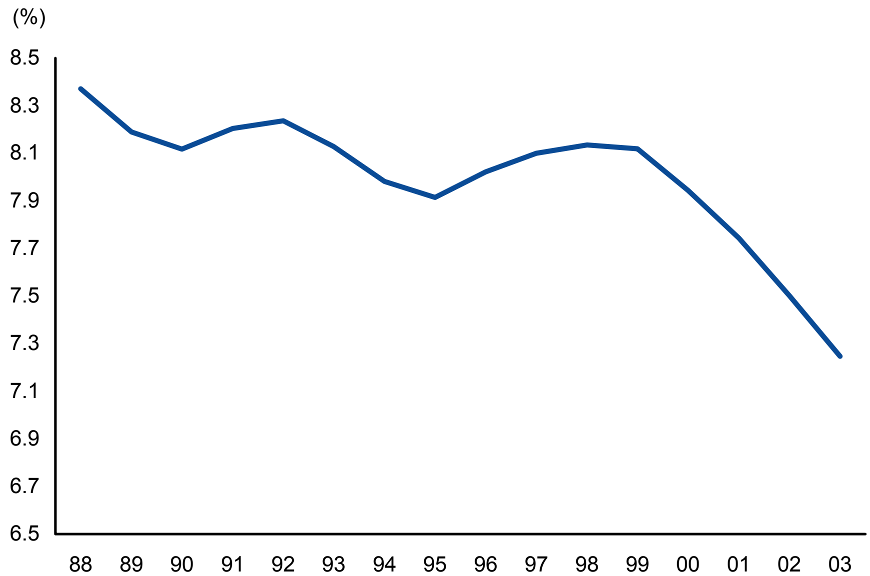
Display 1: U.S. Manufacturing Capital Stock Too Small
Net Stock: Manufacturing as a Percent of Total Fixed Assets

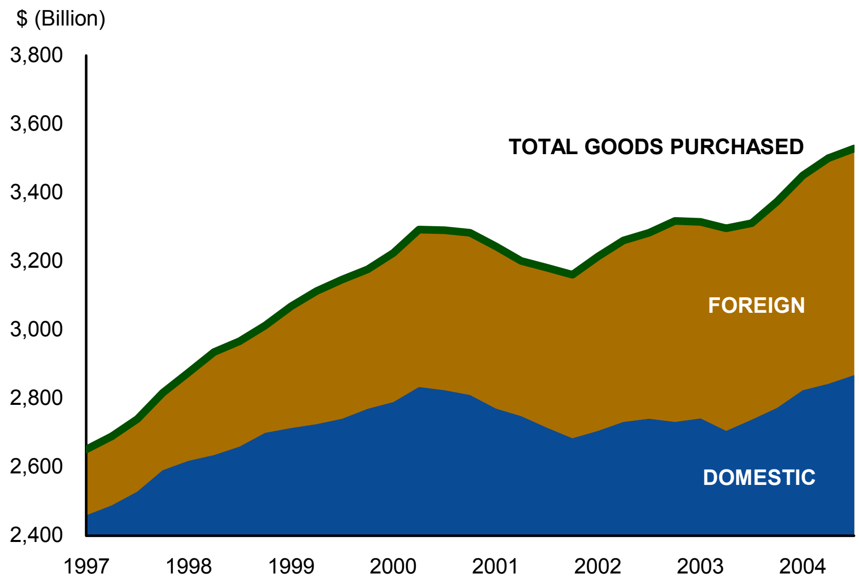


Source: Bureau of Economic Analysis, Haver Analytics and Alliance Fixed Income

In recent years, a combination of plant closings and reduced investment has led to a sharp decline in the net capital stock of the manufacturing sector. A major new investment cycle is needed to reverse this trend.

Display 2: U.S. Production Capacity Cannot Satisfy Domestic Demand

Origin of Goods Purchased in the U.S.: Domestic vs. Foreign

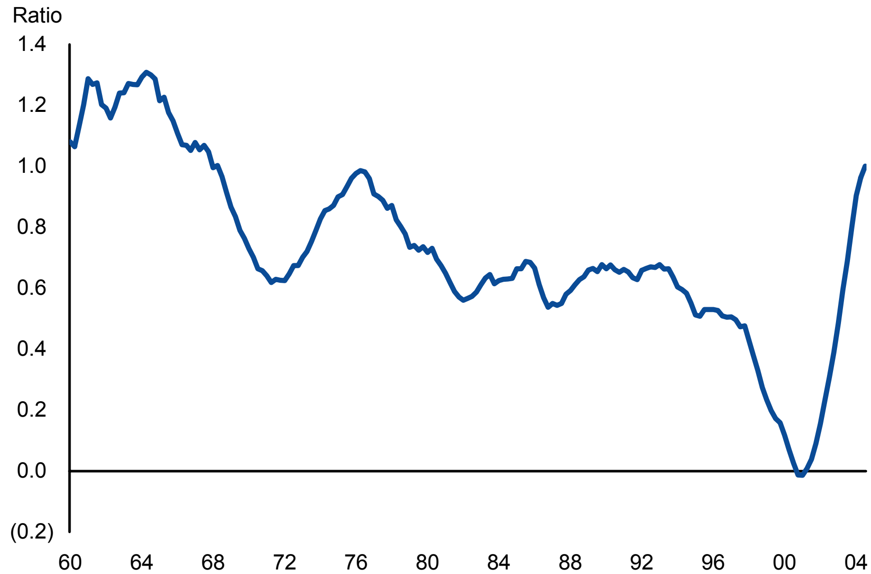


Source: Bureau of Economic Analysis, Federal Reserve Board, Haver Analytics and Alliance Fixed Income

Our analysis shows that imports have accounted for roughly 60% of the incremental increase in the purchases of consumer and business purchases since 1998. U.S. industrial capacity will need to grow to reverse this negative trend in external trade and in the current account.

Display 3: Companies Awash in Cash

Ratio of Free Cash Flow* to Capital Spending



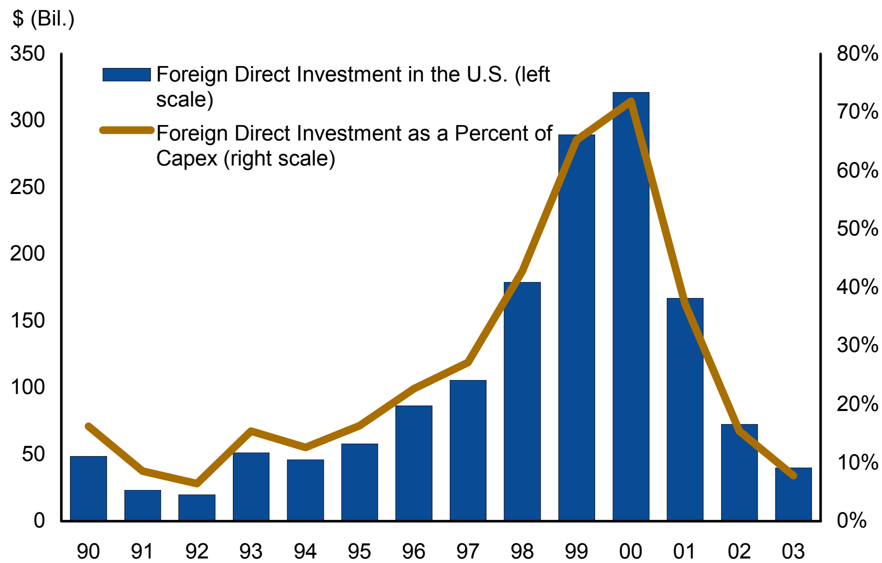
**Three-year sum*

Source: Bureau of Economic Analysis, Haver Analytics and Alliance Fixed Income

We estimate that U.S. corporations have generated nearly $1 trillion in free cash flow during the past three years. Measured against business spending on equipment and software, this is the largest cash-flow "war chest" since the early 1960s.

Display 4: Foreign Direct Investment Will Play Important Role in New Investment Cycle

Foreign Direct Investment in the U.S.



Source: Bureau of Economic Analysis, Federal Reserve Board, Haver Analytics and Alliance Fixed Income

The sharp fall in the dollar is expected to attract major new foreign direct investment to the U.S. Higher FDI translates into new technology, a more stable source of current-account financing, more jobs and, eventually, import substitution and export expansion.