Current Economic Conditions

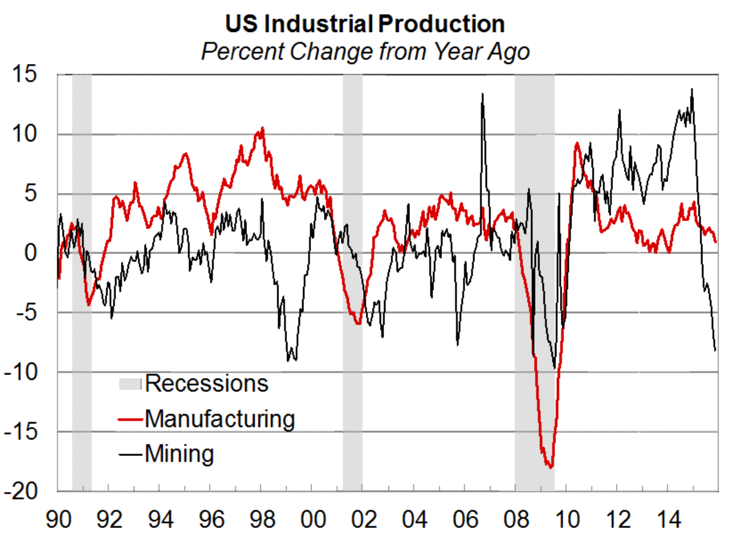
Robert C. Fry, Jr., Ph.D. December 16, 2015

MANUFACTURING RECESSION? NO, BUT IT SURE FEELS LIKE ONE

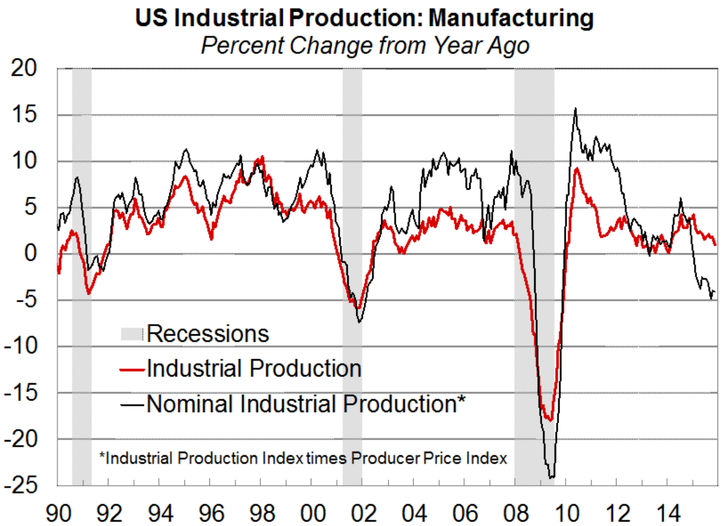
I've heard several analysts in recent weeks say that "we're in a manufacturing recession." I object to this characterization on two grounds. First, a recession is a pronounced, prolonged, and **pervasive** decline in economy activity. A decline in any one sector of the economy is not pervasive enough to be called a recession. You can speak of a manufacturing decline or manufacturing contraction, but when you use the term "manufacturing recession," you show that you don't understand what a recession is. (Ditto for inflation. An increase in prices in one sector of the economy is a price increase, not inflation.)

More fundamentally, the U.S. manufacturing sector is **not** contracting. Industrial production in U.S. manufacturing remained unchanged at a post-recession high in November and was up 0.9% year-over-year. The Institute of Supply Management's Manufacturing Production Index **was** below the neutral level of 50 in November, but a reading of 49.2 for one month signifies neither a pronounced nor a prolonged decline. The manufacturing sector **is** under-performing the overall U.S. economy due to the strong dollar and weakness in the rest of the world, and the leading indicators I track suggest softness in manufacturing will continue in the next few months, but we are not in a "manufacturing recession."

One possible reason that people are too negative about U.S. manufacturing is that they are using total industrial production as their primary gauge of manufacturing activity. Total industrial production has been up in only two of 11 months this year and was down 1.2% year-over-year in November. But manufacturing accounts for only 72% of total industrial production. Mining accounts for 18%, and utilities account for the remaining 10%. Total industrial production is down because mining output, including production of coal, oil, and natural gas, is declining in response to lower oil and gas prices. While manufacturing output was up 0.9% year-over-year in November, mining output was down 8.2%. In addition, utility output was down 7.6% year-over-year in November; it has been held down by mild weather, which has reduced demand for natural gas and electricity used to heat homes and businesses. The Federal Reserve should change its headline measure to (and analysts should focus on) industrial production in manufacturing, not total industrial production. Short-term movements in total industrial production often tell you more about the weather and oil prices than they tell you about the economy.



Another reason for negativity about U.S. manufacturing is that businesses tend to focus on nominal (current-dollar) measures of growth, including price changes, rather than on real (volumetric or inflation-adjusted) measures like industrial production. While the production of manufactured goods is above year-ago levels, the prices of manufactured goods have declined so much that sales in dollars have declined. These price declines reflect both the strengthening of the U.S. dollar, which has reduced the dollardenominated costs of foreign competitors, and the pass-through of lower energy prices forced by competitive pressures. The U.S. Producer Price Index for Total Manufacturing Industries was down 5.0% year-over-year in November! If you multiply the industrial production index by the producer price index to get an index of the dollar value of U.S. manufacturing production, you find that "nominal industrial production" is down 4.1% year-over-year. In the past, nominal industrial production has declined only during recessions. Consequently, for business leaders and equity analysts who are accustomed to dealing almost exclusively with nominal magnitudes, this feels like a recession, even though economists who focus on real magnitudes would not consider it one. More broadly, while real GDP growth is only slightly below normal, nominal GDP growth, at 3.1% year-over-year, is at a level that before 2013 was only seen around recessions.



While the decline in the nominal (dollar) value of industrial production makes it feel like a recession, the current state of manufacturing is best characterized as stagnant rather than in decline or recession. This stagnation is by no means confined to the United States. Total industrial production indexes published by the CPB Netherlands Bureau for Economic Policy Analysis show that growth in global industrial production has nearly ground to a halt in 2015. Production was up just 0.6% from December 2014 to September 2015, and the data behind that calculation take Chinese data at face value. Except for Emerging Asia, which includes China, and Middle East and Africa, production was down in most regions. Industrial production in manufacturing has risen by less than 1% over the last year in the United States, Japan, and Germany. But production is up 2.4% for the European Union as a whole, with most of the growth in Ireland, Spain(!), Sweden, and the emerging economies of Central Europe. Elsewhere, only India, Malaysia, and Vietnam show strong growth. At the other extreme, production has contracted sharply in Russia and has collapsed in Brazil. Official data show 6.2% year-over-year growth in China, but data on individual industrial products suggest that production has really been essentially flat over the last year.

As I discussed last month, I don't believe that manufacturing will grow as fast as the overall economy over the long run, but I still believe that low oil prices are good for economic growth in general and for industrial production in manufacturing in particular. Contrary to what some analysts tell us, consumers **are** spending some of the money they're saving on gasoline and heating oil, but booming motor vehicle sales aside, they're spending it more on "experiences" like travel, dining out, and entertainment than on goods. Real (inflation-adjusted) personal consumption expenditures were up 2.7% year-over-year in October. Manufacturing could be further boosted by growth in housing construction, as household formations delayed by the weak economy start to catch up with adult population growth. Residential building permits surged in November. Industries most likely to benefit are those that make building materials and those that make the appliances, furniture and furnishings needed to furnish new houses and apartments.

There is a risk that declines in **nominal** industrial production could ultimately cause declines in **real** production. This could happen at the micro level if weak nominal sales and earnings prompt companies to cut employment and capital spending or at a macro/financial level if the weakness causes defaults or dividend cuts. But if the declines in the prices of manufactured goods are indeed the result of the stronger dollar and lower prices for oil and other commodities and not a true deflation, they will end when the dollar and oil prices stabilize or reverse direction. The Federal Reserve raised the federal funds rate by a quarter of a percentage point today. While this move has dominated financial news for months, it will have little impact on the overall economy. It will have a significant impact on U.S. manufacturing only if Fed tightening combined with looser monetary policy by other central banks causes the dollar to strengthen further.