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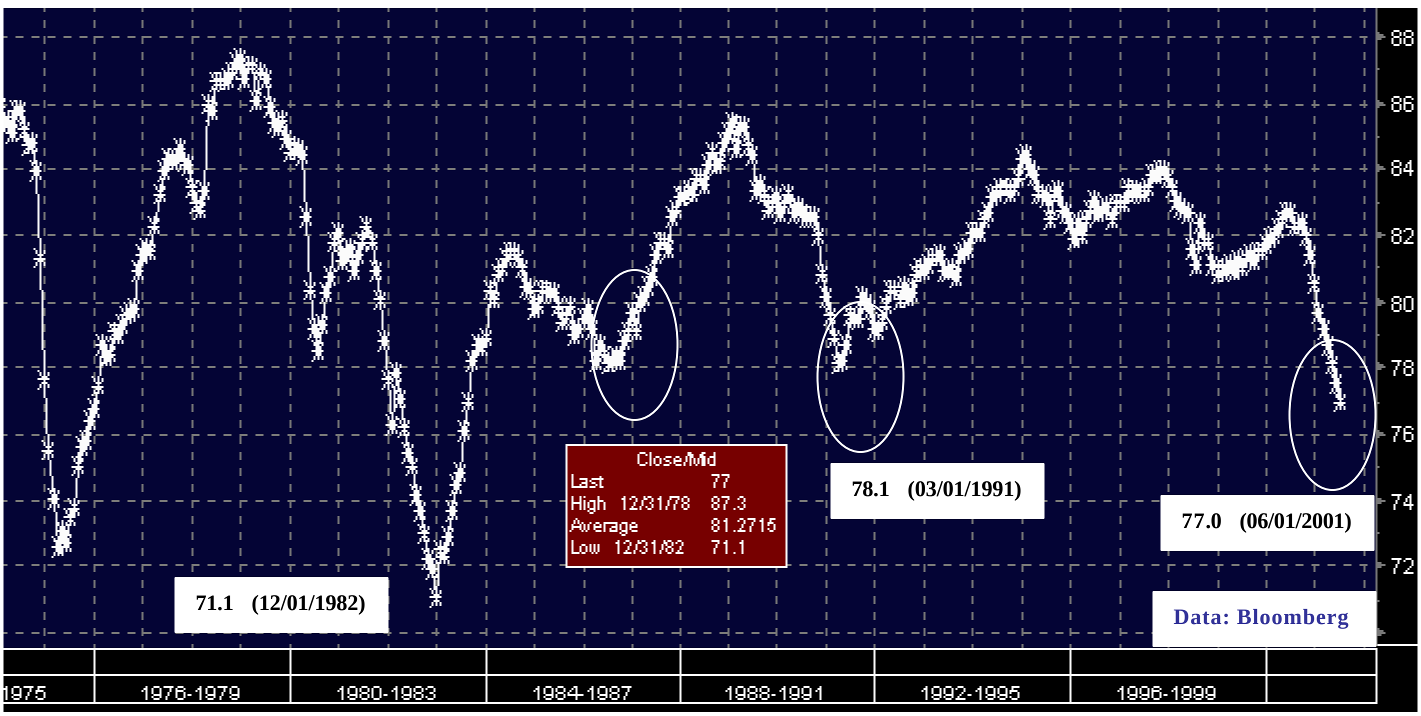
Capacity Utilization and Industrial Production: a puzzle?

Capacity Utilization figures are signaling a recession, yet the consensus forecast has GDP moving up in QIII and QIV. Similarly, unemployment rate forecasts are distinctly different (lower) than in prior recessions and inflation (going lower) is not a problem.

Even with a downward revision in QII, the consensus GDP forecast would make Capacity Utilization a false 'signal.'

Is this a data problem? Do we have a 'vintage capital' issue with older capacity counted but not likely to be used? Or is this an aspect of 'hollowing out' and global supply chain management? Are some vintages production 'fragments' that have been globalized?

Figure 1. Capacity Utilization 1975-2001: another puzzle of the 2001 Growth Recession



Capacity utilization has dropped to levels not seen in the U.S. economy since the 1982 recession, surpassing the low of 78.1 during the 1990/91 disturbance. Since the market is focused on whether the consumer will "hang in" and consumer's spending is said to reflect actual or anticipated unemployment levels, what about comparisons of unemployment this time to past disturbances? While unemployment is a notorious lagging indicator, note that in the 1991/92 episode, it rose to 7.8% in June 1992. Currently, market expectations are that unemployment will rise in the future to a peak in the mid 5's. Is this an inconsistency?

PAST HISTORY: To observe a lower capacity utilization number, we have to go back to the 1982 recession that occurred in a strikingly different inflationary and employment environment. (Federal Funds rose to 19.1% on a monthly basis in June 1981 followed by unemployment rising to 10.8% in November 1982). **Capacity utilization fell to 71.1 in November 1982, a figure more comparable to the low of the 1974/75 recession.** This is a puzzler.

The current capacity utilization level approximates the 1982 disturbance, but the overall environment of lower interest rates and lower (forecast) unemployment is distinctly more benign than that of 1982. With forecast unemployment in the low mid 5's (compared to the current level of 4.5% in July 2001), the current cyclic disturbance could easily claim a "this time its different" label. What does a low capacity utilization number tell us in terms of the likely depth of recession or the recovery path?

GDP SCENARIOS: Some analysts still assert a V yet to come, while others favor U's or L's (of various shapes) depending upon whether the forecaster sees a modest beginning to a more normal recovery or a long pall hanging over the economy into 2002! (One forecaster uses the "square root" notation to signify a rebound that first seems V-like and then flattens, largely due to the effects of the so-called 'global trade recession')! Whatever the scenario going forward, the low level of capacity utilization suggests that a considerable amount of capacity has been added, and normally, **such a low level of capacity utilization would signal a more serious recession.**[1] Is it possible that the current fall in capacity utilization simply reflects output levels that have not plunged drastically while the measure of capacity has increased disproportionately?

Could it be that the capital stock additions that occurred during the "boom" were "different this time," originating in the 'investment boom' aspect of this disturbance? Put another way, in order to create the index number for capital (the denominator of the capacity utilization number), capacity changes over the period have to be "added together." This suggests a kind of a 'vintage capital stock' problem. The difficulty with counting the earlier vintages is that they may never be used again, even though they are not fully written off the corporation books! In short, "newer machines" are better than "older machines" and that gradation in the quality of capital will 'idle' some of the older capacity permanently. Maybe its time to prune the capacity index number?

RECONCILIATION: If this is just another dimension of the 'Productivity Shock" that the economy experienced, how should idled capacity that will never be used be taken into account? This is the "efficiency" side of capacity expansion. Maybe the "new stuff" is much better than the "old stuff," but the index number that measures capacity does not properly reflect those efficiency changes. Adding "old" and "new" vintages together may not produce a data series that is an "economically relevant" series in a period of rapid technology change.

That would reconcile the observed level of capacity utilization and the assumption that the economy is not in a deep recession. It also suggests something else about recovery. It suggests that "new innovations" will have a lot to do with future GDP expansion. Why? **Additions to capital stock will be 'best of breed' innovations that will also idle older vintage capital so that investment output growth could occur without a 'normal' rise in the capacity utilization rate.**

When new orders slump, the first line defense of the CFO is to bring back cash flow and that is why investment spending collapses. That cannot be a permanent strategy for rebuilding profits because with weakened pricing power, profits can only be can only be improved by cost saving innovations. That requires using new capital stock that is inherently more efficient and productive. In turn, it should mean that investment spending itself must increase in those companies where pricing pressue has resulted in falling gross margins. This should be more the case in a deflationary setting---which is what we will observe now if the fear of further output declines attenuates.

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[1] Or the other data are soon to get much worse in order to resolve the inconsistency. This effort **assumes** that is not the case, consistent with most economic forecasts, and tries to resolve what might be wrong with the capacity utilization number. A third explanation may be that some production fragments are now 'overseas.' See footnote 2 below.

THE JAPANESE CASE: This kind of response seems paradoxical, but perhaps Japan's recent experience in a deflationary environment is suggestive? During Japan's bout of deflation, what growth there was came from industrial sector investment spending---prompted by the need to improve corporate profits. Japan was floated, at least for 2000, by a wave of investment spending in spite of the fact that the Japanese capital stock was already too large. Put another way, too little of the 'old capital stock' had been trashed, and its continued 'existence' impeded a full recovery.

Old capital that will never be used shouldn't be counted as capital. In Japan, they don't "mark to market," sufficiently, but here, we 'write it down.' In some sense, what has kept Japan from recovering was an insufficiency of capital stock trashing in many other areas of the economy and the failure to reignite spending by a dubious consumer who had lost faith in Japanese economic and political management. More than one analyst has spoken of the need for capital to exit many Japanese industries (e.g. banking).

CAPITAL EXIT: In the U.S., we have had a significant amount of capital stock trashing. The first wave is frequently a matter of accounting---**write-offs**! The next wave is actual exit from distressed industries or industry segments. Pieces of business are sold off, spun out or closed down. This is a triage strategy for the corporate sector where the firm salvages what it thinks is most likely to survive and trashes the rest. Yet, this process of cleansing the firm's excesses, provides the basis of a revival in investment spending. In the meanwhile, during this 'capital exiting process,' the consumer is the key to the economy's ability to maintain some modest growth. Fed policy in this cycle has implicitly recognized this challenge.

MONETARY POLICY: The Fed's policy has been to place a **life raft** underneath the consumer through continued interest rate cuts. This portrayal of Fed's policy throws a different light on the much mooted issue of the **potentcy of monetary policy** in an investment boom collapse. By the 'life raft' standard, Fed policy has actually been quite successful. The rate of growth of consumer expenditures has fallen, but it is still positive (at something like 2-3% per annum). That is largely the result of lower rates on mortgages and on home equity lines working its way through the economy. The policy also provides a mechanism for firms to run down their inventories through significant price discounts to both industrial and consumer channels. The same analysis also suggests a key to the Fed's timetable. The Fed has to stay in the game until new investment revives, the investment that will be required to rebuild corporate profits. At that point, consumption expenditures will not be the sole source of new GDP growth.

POSITIVE SIGNALS: What kind of investment is likely to take place in such an environment? We should be looking for the latest vintage capital that makes older vintage capital obsolete---whether our statistcs count it properly or not. The latest vintage capital items should serve as early warning indicators that the economy is about to mount a charge. If we get such an early warning indicator for a cyclical upturn, it will also signal that the Fed will soon stop its program of monetary ease.

The foregoing suggests we should be looking at new orders, and in particular the new orders that are the leading edge of the most recent 'vintage' capital.[2] It is well known that the NASDAQ and various components of the 'new orders' series are highly correlated. Perhaps that is the next place to look?

[2] Since this theme is exploratory and certainly not definitive, one other hypothesis about the "excess capital stock" may be worth investigation. Consider the expansion in outsourcing or global supply chain management that has occurred during this boom. Frequently, firms have "shut down" or "idled" lines while purchasing the same or similar inputs from abroad. Unless the capital stock index is adjusted for these 'shut downs,' some portion of the 'older capital stock,' still on the books will actually never be used, even when expansion occurs. The orders will be filled overseas. The old 'vintage' capital is replaced by a new 'vintage,' that is located abroad!