



Economics Group

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Should We Worry About Slow Growth in Capacity Utilization?

Capacity utilization has declined since the 1980s and remains depressed during this expansion. Lackluster manufacturing industrial production is the likely culprit and has yet to surpass its pre-recession peak.

Are Lower Capacity Utilization Rates a Cause for Concern?

Throughout the current cycle, capacity utilization, or the share of actual output achieved relative to potential output, remains 4 percent below its pre-recession peak (top chart). Capacity utilization has trended downward since the 1980s, while industrial production has accelerated. Should we be concerned about the slowdown in capacity utilization? And, does it make sense to forecast positive industrial production growth, or simply acknowledge that capacity utilization will likely remain lackluster in future cycles?

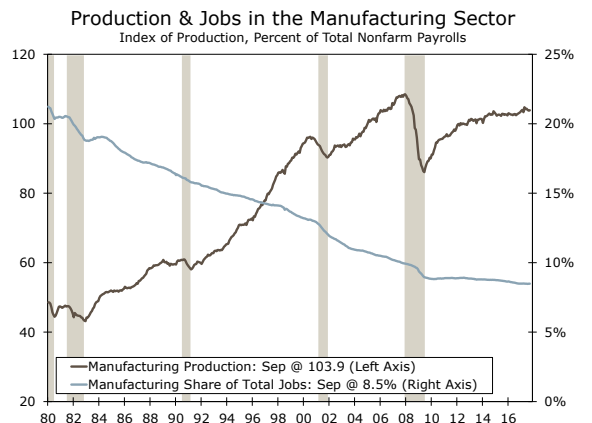
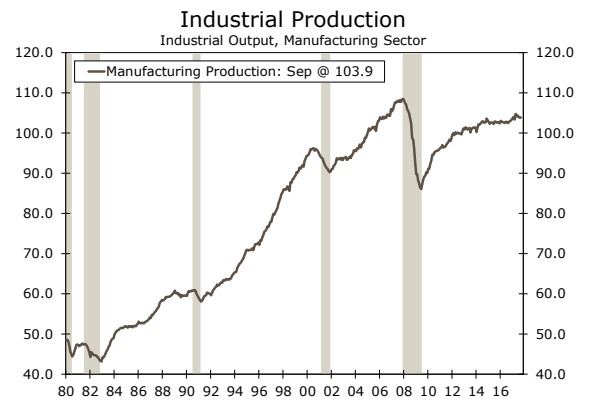
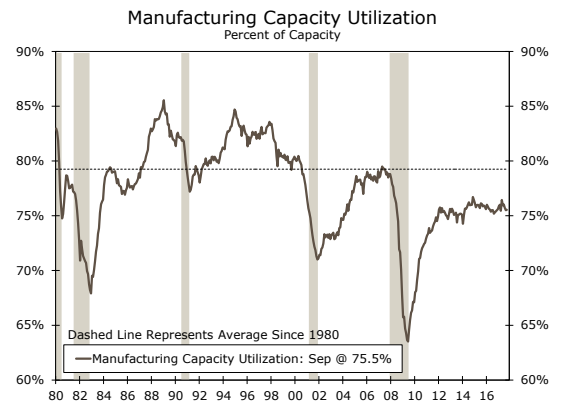
Industrial Production Leaves Capacity Utilization in the Dust

The answer to this question lies in the fundamental divergence between manufacturing industrial production and capacity utilization over the past few cycles. Until the most recent expansion, manufacturing industrial production has peaked at higher levels after each recession (middle chart). Manufacturing production rebounded 14.7 percent above its pre-recession peak after the 1973 recession, and 27.2 percent above its pre-recession peak after the 1981 recession. The biggest expansionary gains occurred after the 1990 recession, when manufacturing industrial production rebounded 55.3 percent above its pre-recession peak. Even in the expansion after the 2001 recession, often characterized as weaker than average, manufacturing production expanded more than 10 percent above its pre-recession peak.

However, these periods of strong manufacturing industrial production growth occurred alongside the opposite trend in capacity utilization. In every cycle since 1982, capacity utilization has peaked at a lower level than the previous cycle (top chart). In the current cycle, manufacturing capacity utilization is still 4 percent below its pre-recession peak. This should not come as a surprise after recognizing the broader trend in declining capacity utilization rates over the past few decades.

Manufacturing Production Likely Explanation for Divergence

What is surprising, however, is that aside from a temporary peak in industrial production as low oil prices increased mining output in late 2014, manufacturing industrial production is still 4 percent below its pre-recession peak. Manufacturing is the most heavily weighted industrial group, comprising more than three-quarters of total industrial production. Although factory hiring has rebounded this year, the broader downward trend in the sector after the manufacturing boom of the 1970s will likely continue to weigh on growth. Manufacturing employment has declined from 21 percent of total nonfarm employment in 1980 to only 8.5 percent today (bottom chart). Low capacity utilization rates alone may not be cause for concern, but depressed manufacturing output and slow employment growth could weigh on inflation.



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