

# Chicago Fed Letter

## Manufacturing sector critical in Midwest recovery

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With the national economy beginning to show signs of life, economists from around the Midwest gathered to discuss the outlook for the region in 2002. Because the consumer sector, which remained surprisingly resilient through the downturn, is expected to make only a modest contribution to economic growth this year, many analysts are expecting lower vehicle sales and a modestly weaker housing sector. Several factors indicate the recovery in manufacturing is likely to be restrained.

In November 2001, the National Bureau of Economic Research stated that the U.S. economy had entered a recession beginning in March 2001. This ended the longest economic expansion in U.S. history. With some early indications that the bottom of the downturn was near, the Federal Reserve Bank of Chicago invited economists from around the region to attend an Economist Roundtable discussion on February 8, 2002, focusing on the outlook for the Midwest economy in 2002 and beyond. This *Chicago Fed Letter* summarizes the workshop presentations.

Recessions are typically characterized by a decrease in consumer spending, but this downturn was different.

### Midwest economy more cyclical

National economic growth had been running at a torrid pace through the second quarter of 2000. Real gross domestic product (GDP) growth in the second quarter of 2000 compared with a year earlier was 5.2%, the largest increase of the ten-year expansion. Overall economic activity slowed dramatically over the course of the following six quarters. Between the third quarter of 2000 and the fourth quarter of 2001, quarterly real GDP growth averaged 0.8% (seasonally adjusted annual rate or saar), significantly below the 3.7%

(saar) pace that occurred between the second quarter of 1991 and the second quarter of 2000.

This particular recession has been very unusual. One normally associates a recession with a decrease in consumer spending, which represents two-thirds of the economy, but this did not occur during this downturn. In fact, real personal consumption expenditures during the second quarter of 2001 through the fourth quarter of 2001 averaged 3.2% (saar), with the highly cyclical durable consumption expenditures increasing 15.7% (saar). Real private residential investment rose by 1.1% (saar) over this period. We need to look at the business sector to find the weakness in the economy.

Gross private domestic investment excluding residential investment averaged losses of 19.7% (saar) during the last three quarters of 2001. A large part of the decline in business spending was due to substantial contractions in business inventories that occurred during 2001. A record inventory reduction in real dollars was set in the third quarter 2001 with a loss of \$61.9 billion, only to be blown away by the following quarter's \$119.3 billion reduction. The fourth quarter's inventory contraction was

not only the largest real dollar amount but the largest decline as a percentage of GDP. In the fourth quarter of 2001, items taken off the inventory shelves amounted to a record share, representing 1.3% of all the goods and services sold during that quarter.

With a large part of demand for products being fulfilled by depleting stocks, production fell sharply over the course of 2001, with manufacturing output falling 6.1% in the fourth quarter compared with a year earlier. Capacity utilization for manufacturing fell to 73.1% in the fourth quarter, the lowest rate since the first quarter of 1983. The large amount of excess capacity has been a drag on growth. Additions to capacity fell to a record low of just above 1% in early 2002, after having approached nearly 8% in the late 1990s. This has also translated into significant declines in capital goods orders and shipments over the course of the last year.

While manufacturing has become a smaller part of the Midwest economy, it is still the key sector distinguishing the Midwest from other regions. Manufacturing jobs in the U.S. last year were 3.8% lower than at the beginning of this expansion, but Midwest manufacturing jobs increased by 4.1% over the same period. As a result, the Midwest's share of the nation's manufacturing jobs rose from 17.6% in 1991 to 19.0% last year.

Manufacturing output in the nation fell by 6.1% in the fourth quarter of 2001 compared with a year earlier, but the decline in the Midwest was almost double that figure—11.9%. This discrepancy between the nation and the region is fairly typical during recessions. The Midwest tends to have more cyclical industries. With less than one in five manufacturing jobs, the region produced 36.7% of all light vehicles made in the country. The Midwest also produces 36% of all the steel in the nation. These sectors tend to be very procyclical, and Midwest manufacturing output has experienced relatively high losses as a result.

As has been the case for the nation as a whole, the housing industry in the

Midwest has been quite robust. Housing starts in the Midwest were over 17% higher in the fourth quarter of 2001 than in the same period a year earlier. This was quite a bit higher than the 2.6% increase experienced by the nation. Similarly, new privately owned buildings were 9.3% higher in the Midwest versus 2.4% higher for the U.S. in the fourth quarter of 2001.

Employment losses in the Midwest during 2001 slightly exceeded the national level. Total employment in the fourth quarter of 2001 was 0.9% lower in the Midwest and 0.6% lower for the nation. The U.S. unemployment rate rose by 1.6 percentage points to a level of 5.6% between the fourth quarter of 2000 and the fourth quarter of 2001; the Midwest's rate showed the same percentage point increase, rising from 3.7% to 5.2%.

#### Midwest economy in the year ahead

The economic news received so far in 2002 has been more positive than many analysts expected. As it is becoming more apparent that the economy has reached the bottom of the downturn, the question now becomes how strong will the economic expansion be? Typically during recessions consumer spending falls and this leads to an increase in pent-up demand; individuals do without items, usually durable goods, during the downturn, and then once the expansion begins, this delayed demand fuels large increases in economic growth. The surprising

for expansionary growth. Many analysts are expecting lower vehicle sales and a modestly weaker housing sector this year.

As already discussed, the downturn has been led in large part by the manufacturing sector, which will need to expand to generate more positive growth rates for the economy as a whole. However, a number of factors suggest that this sector may experience only a modest recovery. While inventories have been pared back sharply, many firms remain cautious about rebuilding their stocks, mainly due to concern about consumer spending. However, given the contractions that have taken place during 2001, as long as firms stop cutting, inventories will add over 1 percentage point to GDP growth on an annual basis. Firms still have substantial excess capacity, as well as reduced profits, and this will restrain capital spending in the near term.

The Economist Roundtable group forecast that employment in the Midwest will decline by 0.7% during 2002 compared with 2001 (see figure 1). Four of the five states in the Seventh Federal Reserve District are anticipated to experience a decline. Manufacturing-intensive Indiana is forecast to lose the most jobs, shedding 1.2% in 2002. Illinois, Michigan, and Wisconsin are expected to show employment declines of 0.8%, 0.7%, and 0.6%, respectively. Only Iowa is expected to show an increase.

#### 1. Nonfarm payroll employment, annual percent change

	Illinois	Indiana	Iowa	Michigan	Wisconsin	Seventh District
2000	1.2	1.4	0.7	2.1	1.8	1.5
2001	0.0	-0.9	0.5	-0.1	0.2	-0.1
2002f	-0.8	-1.2	0.7	-0.7	-0.6	-0.7

SOURCES: Bureau of Labor Statistics data as of February 8, 2002; forecast (f) data from Midwest Economist Workshop participants.

resiliency of the consumer sector during 2001 has been the major factor underlying the very mild recession that the nation's economy has experienced. But for this very reason, the U.S. economy cannot look to consumer spending to generate significant strength

#### Illinois

According to a state labor economist, conditions in southern Illinois have generally been better than in the rest of the state. For example, coal mines are opening or expanding operations, manufacturers have been adding a few

workers to their payrolls, and construction has been good. In other areas, conditions have been less positive. For example, in Decatur and Rockford, laid-off manufacturing employees are nearing the expiration of their unemployment benefits, and in Peoria there are a number of temporarily laid-off factory workers. Statewide, the number of manufacturing jobs has fallen to around the level that existed in 1947.

Most roundtable participants forecast a moderate recovery for Illinois, with

been down significantly. The only area that has seen an increase has been sales tax receipts, but that is largely because at this time last year there was no gasoline tax.

#### **Indiana**

According to an economist from the Fort Wayne area, Indiana's economy peaked earlier than the national economy, entering recession as much as three months before the U.S. The recession has been focused in durable goods manufacturing, while some

the university economist, Indiana is currently facing a \$1.3 billion revenue shortfall, \$750 million of which is due to past tax cuts.

#### **Iowa**

According to a university economist, the recession that began in 2001 had a very mild effect on the Iowa economy. Real personal income in Iowa rose 2.0%, compared with 0.4% in the rest of the nation and an average decrease of 2.5% during past recessions.

The outlook for the near term is for Iowa to weather the current downturn in good fashion and make a solid recovery in 2003. Based on weak property-related income, real personal income is forecast to increase 1.9% in 2002 and then accelerate to 3.0% in 2003. Nonfarm payroll employment is forecast to recover from the 0.5% increase in 2001 to grow at 0.7% in 2002 and then pick up further to 2.3% in 2003. There is anecdotal evidence of firms adding workers in 2002, including a recreational vehicle manufacturer that has plans to expand its operations and an insurance firm that will likely be adding workers in Des Moines. However, the downside risk is that the supply of workers may not be able to meet the demand. The state's population growth has averaged around 0.3%, so it may need to import many of the workers to fill those jobs.

### **In Illinois, the temporary help sector has seen no pick-up yet in demand from manufacturing or information technology firms.**

the labor economist adding, "I do not see any clear-cut drivers of growth." The current federal budget proposal calls for a \$250 million cut in construction funds for Illinois. Other industries are merely steady. The state economy will probably bottom around the second quarter, according to the labor economist. The first area to turn around will probably be temporary help employment; contacts in that industry say that they have seen no pick-up yet in demand from manufacturing or information technology firms.

The current consensus outlook calls for a 0.8% decline in nonfarm payroll employment. Forecasts for manufacturing employment ranged from -1.5% to -2.7%, with the labor economist adding that the decline should be evenly split between durable and nondurable goods manufacturing. Forecasts of the unemployment rate ranged from 6.0% to 6.3%. A university economist was optimistic that Illinois's unemployment rate would be below the 6.3% rate forecast for the U.S., because forward-looking data (unemployment insurance claims, hours worked, and housing permits) for the state all look better than comparable data for the rest of the nation.

The economist with the state budget office noted that state tax revenues have

other industries have continued to see employment increases. A university economist observed that Indianapolis has seen an increase in employment, while the rest of the state, led by Fort Wayne, has seen job declines.

The Fort Wayne economist noted that the high concentration of manufacturing jobs and the weak performance of auto suppliers in the area have exacerbated conditions in northeast Indiana. Beyond the manufacturing job losses, commercial construction is down 30% in Fort Wayne, housing permits have been flat for the past six months, initial unemployment claims are still rising, help wanted ads are down sharply, and industrial electricity usage continues to decline steadily.

The university economist forecast that after dropping 1.1% in 2001, the decline in total employment will moderate to 0.8% in 2002, and then employment will increase 1.0% in 2003; though the economist expects a sharper decline in manufacturing employment in 2002. Real personal income growth should moderate from 1.6% in 2001 to 1.4% in 2002, before picking up to 2.4% in 2003. The unemployment rate forecast is for 5.1% in 2002 and 5.3% in 2003, compared with 3.6% in 2001. One of the risks to the forecast is the state's budget problems. According

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## Michigan

During 2001, the Michigan economy entered one of its more moderate recessions. Nonfarm payroll employment fell 0.2%, real personal income rose a modest 0.1%, and the unemployment rate rose from 3.6% to 5.0%—but was the lowest rate recorded during any recession since 1970. Employment conditions in Michigan's industries were varied. Manufacturing employment fell 4.2%, led by an 8.2% drop in transportation equipment jobs; however, the declines were moderating toward the end of the year. Services employment increased 0.2%, but declines were becoming more severe at the end of the year—particularly in tourism-related services.

Two economists, one from Detroit and the other from the state government, provided forecasts for 2002. Both expect employment conditions to firm in the second half of 2002, but generally to be weak for the year. Employment for the entire year should drop by 0.7%, but at the end of the year the number of jobs should be about equal to the number of jobs at the end of 2001. The economist from Detroit added that cyclical conditions may contribute to further manufacturing job losses, while financial, insurance, and real estate and trade employment "will probably be okay." Given the weak employment

outlook, real personal income is forecast to be flat, and the unemployment rate is forecast to rise to 6.5%, the highest rate in nine years.

There are two main risks to the forecasts. One is that the strong dollar will lead to a large deterioration in the domestic vehicle share of total sales and contribute to higher job losses. The state economist forecasts that the domestic share of the market will inch down from 82.0% to 81.7% in 2002, but a strong dollar could lead to a larger decline. The other risk is the fallout from Kmart's bankruptcy. With its headquarters in Troy, MI, Kmart employs around 25,000 people in the state. Current estimates have Kmart closing 30% to 50% of its stores nationwide, but one economist speculated that the fallout could be worse because of over-capacity in retail and because Kmart does not have a significant niche in the industry.

## Wisconsin

An economist from the department of revenue noted that in 2001, Wisconsin suffered a fairly mild recession. Nonfarm payroll employment was up 0.2%, the unemployment rate inched up to 4.3%, and real personal income increased 3.1%. The only severe deterioration was a sharp 3.5% decline in manufacturing employment.

The outlook calls for 2002, on average, to be a weaker year than 2001. Nonfarm employment is forecast to fall 0.6%, the unemployment rate is expected to increase to 5.2%, and real personal income growth should slow to 1.1%. The economist commented that "we're not seeing anything happy" for manufacturing employment and forecast a 4.9% drop in factory jobs. This would imply six consecutive quarters of decline in manufacturing jobs.

In 2001, state tax receipts reflected national trends: a dichotomy between sales taxes and income taxes. Sales tax receipts continued to grow strongly, though the economist noted that much of the growth was due to strong vehicle sales. Income tax revenue, based on withholding taxes, dropped significantly, reflecting layoffs and slower job growth in the state.

## Conclusion

The challenge facing the Midwest economy will be how quickly and robustly the manufacturing sector recovers. There are a number of factors that seem to indicate that, while we have turned the corner on the economic downturn, the recovery will be more restrained this time than we would typically expect.

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