

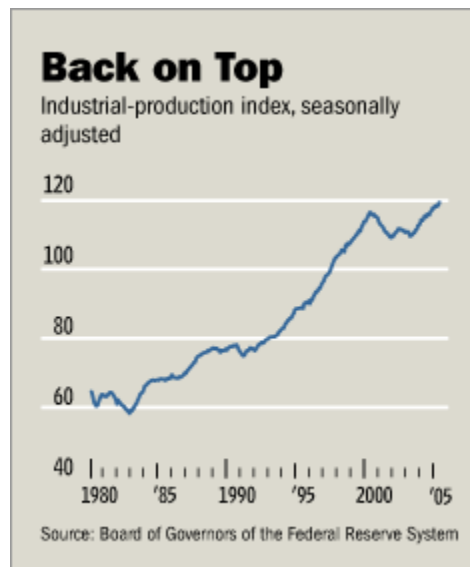
Manufacturing Sector Displays Unexpected Vigor

Output Climbs as Payrolls Shrink; Surging Demand For Business Equipment

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The import-heavy shelves of Home Depot, Wal-Mart and Best Buy paint a grim picture of the health of the U.S. industrial sector, which doesn't appear to be producing much of what American consumers are buying.

But that isn't the full picture. While employment keeps declining at American factories, they are cranking out more products than ever, and they are running closer to capacity than they have in half a decade.



In the past year, the growth in output of high-tech equipment, machinery and aerospace products has outpaced overall economic growth. Even production of motor vehicles -- despite the problems of **Ford Motor Co.** and **General Motors Corp.** -- is growing at a healthy pace, expanding by 8.5% in the past 12 months as foreign auto makers have increased output in the U.S. to win market share. Production of some consumer products -- like food and toiletries -- is also rising.


"Contrary to the view out there that American manufacturing is dead or dying, [production] is growing at a pretty good clip," says Joseph Carson, director of global economic research with Alliance Capital Management LP in New York.

It is a counterintuitive view, but the point was underscored Friday with the monthly report by the Federal Reserve on the state of the manufacturing sector. Industrial production rose 0.9% in June, the largest increase in nearly a year and a half.

Rising utility output was an important part of the increase, but so was manufacturing. It rose 0.4% from the month before and now looks to be back on a growth track after a slump in March and April led some economists to worry that an inventory glut could send the sector into another tailspin.

"Manufacturers are putting the second quarter's inventory adjustment behind them and are gearing up for increased demand," Nigel Gault, an economist at Global Insight, an economics research firm in Lexington, Mass., said in an analysis of the Fed's report. When businesses build up too much inventory, they usually reduce output to work off existing stock.

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Read the complete text of Friday's economic reports, and analysis from Briefing.com:

- Producer prices -- [Labor Department](#)³; [Briefing.com](#)⁴
- Business inventories -- [Commerce Department](#)⁵; [Briefing.com](#)⁶
- Industrial production -- [Federal Reserve](#)⁷; [Briefing.com](#)⁸

Two larger trends are at play in the increases. The first is continued productivity gains in the manufacturing sector, which means factories are producing more products with fewer workers. The other is a growing global economy, which allows U.S. producers to expand production even as upstart factories in places like China and Mexico build up market share.

The Fed's index of manufacturing production, which measures the volume of output, now stands 3% above levels seen at the height of the last economic boom. In June, production of business equipment -- computers, industrial machinery, tractors, airplanes and other products used by businesses, rather than consumers -- was up 8.2% from a year earlier, while output of computer and electronic parts rose 15.6%. Information-processing and defense and aerospace equipment also registered double-digit growth rates.

Meanwhile, factories, mines and utilities operated at 80% of their capacity in June. It was the highest level since December 2000, although still below rates seen during much of the 1980s and 1990s.

Some companies say they are feeling the lift. **Boeing** Co.'s orders this year already exceed the total for 2004, thanks in part to orders from overseas. **Procter & Gamble** Co. says demand for soap, baby-care products and diapers is so strong that it has had to add to its facilities in Pennsylvania and Missouri. **Campbell Soup** Co. said last week that it plans to build an \$80 million factory in Everett, Wash. As a result of the move, the company expects its StockPot business, which makes fresh refrigerated soups and sauces for the food-service industry, to boost capacity by 50%.

And amid worries that U.S. manufacturers can't compete with Asian rivals, more of those rivals are looking to produce in America. Hyundai Motor Co., based in South Korea, in May opened a two-million-square-foot plant in Montgomery, Ala., that has the capacity to produce 300,000 vehicles a year.

To be sure, manufacturing isn't expected to reclaim its position as the key locomotive in the U.S. economy, which is increasingly services-oriented. Just as the agricultural sector did during the industrial revolution, manufacturing is shrinking as a percentage of overall economic output. In 2004, manufacturing was 12.7% of gross domestic product, down from 13.2% in 2001 and more than 20% in 1980. While some companies are boosting production in the U.S., many also are moving some production to low-wage countries.

The sector also faces numerous challenges domestically. Manufacturing profits could reach new highs this year, but at \$106 billion in 2004, they were still shy of their 1998 levels, according to the Bureau of Economic Analysis.

Import competition is as intense as ever. High oil prices and rising health-care outlays are putting upward pressure on costs. And the dollar has started to strengthen again, reducing the competitive edge that exporters enjoyed earlier in the year. It all forces manufacturers to work as hard as ever to control costs and increase productivity.

Manufacturing payrolls today are 1.6 million smaller than they were when the economic recovery started in November 2001. More Americans are now employed in health care and social services than in manufacturing, where payrolls stood at 14.3 million in June on a seasonally adjusted basis. That was just a little more than 10% of total payroll employment.

"We need fewer and fewer workers for the same amount of production," says Dean Maki, chief economist at Barclays Capital. "That drives

the perception of the declining manufacturing sector."

Yet some economists say the manufacturing sector is quietly adjusting to a demanding environment by shifting to higher-end products that might not be on many consumers' shopping lists.

In studies on plant shutdowns in manufacturing during the 1980s and 1990s, J. Bradford Jensen of the Institute for International Economics, Andrew Bernard of Dartmouth's Tuck School of Business and Peter Schott of the Yale School of Management found global competition has been hardest on U.S. companies that depend on low-skill workers. Mr. Jensen says these workers tend to be in industries, such as apparel, furniture or leather manufacturing, that produce consumer products recognizable in stores.

Survivors, by contrast, have tended to be in "capital intensive" industries that rely on expensive machines and skilled workers to operate them. These capital-intensive industries tend to produce business equipment that can't be tossed into a shopping cart at Wal-Mart, such as industrial machines, bulldozers or airplanes. "Most people don't buy these things," Mr. Jensen says.

In the past year, compared with the 8.2% increase in the output of business equipment, output of consumer goods has increased by half as much, or 4.1%.

JLG Industries Inc., a maker of construction equipment in McConnellsburg, Pa., is an example of these forces at play. It makes excavators, loading machines and other heavy industrial equipment and has seen sales soar 54% in the U.S. and 75% overseas in the past year, to \$505 million in the three months ended May 1. "We have had to boost production to meet demand," says Juna Rowland, corporate-relations director.

Baldor Electric Co. of Fort Smith, Ark., a maker of generators and electric motors, expects business in linear motors, used to make everything from semiconductors to baggage-handling equipment, to double in the next few years. In response, Baldor is building a new plant, the company announced in March.

Slow growth in places like Europe and Japan has made it harder than expected for many manufacturers to expand overseas. But Mr. Carson, of Alliance Capital, says that is starting to change. He estimates that in May, nearly 20% of all manufacturing shipments ended up overseas, near a historical high. "It gives a sense to me that domestic demand growth around the world is picking up," he says.

Separately last week, the Labor Department said producer prices were unchanged in June and that the core inflation rate, which excludes swings in energy and food prices, fell 0.1%. The decline in the core index was the first since February, and a sign that manufacturers have little leverage to raise prices.

Also, the Commerce Department reported that in June, business inventories edged up 0.1%, an indication that inventory growth is contained despite fears earlier in the year that they were building too fast.

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