Weekly Economic Commentary

May 17, 2013
by Team
of Northern Trust

- Predictions of an American manufacturing renaissance may be premature

- Does the Fed have to worry about deflation?

- The U.S. fiscal deficit is narrowing rapidly

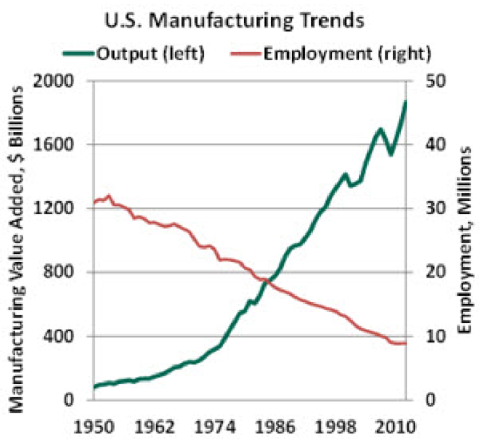
My father designed radio-controlled equipment that was installed in steel mills. An operator could stand on the floor, send signals to an overhead crane from a device on his belt and maneuver ingots weighing several tons. Very modern for its time, the system greatly reduced the risk of injury among workers.

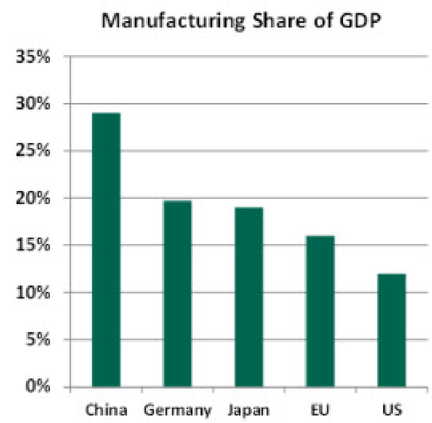
My dad was understandably proud of his contribution to the American manufacturing boom of the 1950s and 1960s. On the odd Sunday, when my mother needed her two sons out of her hair, dad would drive us down to the mill and we'd watch the operation from a distance. We were mesmerized by the process and awed by the economic might it projected.

And then oil shocks hit in the 1970s, emerging markets became competitors instead of consumers, and U.S. manufacturing began a steep decline. The resulting "rust belt recession" made it hard for good Midwestern boys like me to find work. And the "hollowing out" of American industry has been a defining business trend for a generation.

So given that history, please forgive me for being a little cynical about claims that an American factory renaissance is at hand. Granted, energy costs are presently an advantage for the United States, but there are a lot of things that drive decisions on where plants should be located. While it does seem clear that the trend toward offshoring has slowed or ceased, it is not clear that a broad "re-shoring" movement is underway.

There is often a misunderstanding about where American manufacturing stands. For all of the talk of decline, factory output in the United States remains the highest in the world and has grown faster than the overall economy.



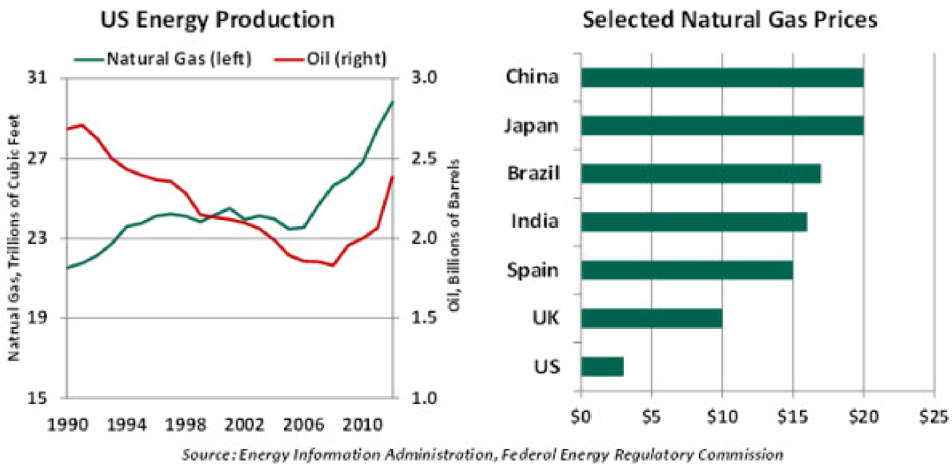


Sources: BEA, BLS, Haver Analytics

The performance of the sector is sometimes judged, unfairly, by levels of factory employment. American jobs in the sector have been declining for decades, but this has less to do with international competition and more to do with technology.

So diagnosing the health of heavy industry requires a little nuance. But these subtleties do not change the basic fact that America's dominance in this space ended long ago. U.S. manufacturing accounts for a much lower share of gross domestic product (GDP) than it does in other nations.

Could the end of that long decline be at hand? Recent trends in world energy markets have raised the possibility that the United States might begin to regain its share of world manufacturing. Technology has led to the discovery of new oil and gas reserves and increased yield from proven reserves. The United States has applied these techniques more aggressively than others, creating an important energy cost advantage.



Excited analysts have been discussing a new era of energy self-sufficiency for the United States. Only about 42% of the oil used in the United States is imported, down from 60% in 2005. The abundance of gas deposits has engineers rushing to use this fuel more widely in commercial and consumer applications. There seems to be clear sailing ahead, and the welcome mat is out for global firms to bring their production back in this direction.

Not so fast.

First, it is not clear how long we will enjoy this energy cost advantage. We are not the only nation on Earth that has found new reserves and has access to the processes to develop them. Environmental concerns may slow or alter the harvesting of new supply. And policy-makers may choose to sell some of our increased bounty to balance our trade picture and strengthen strategic ties.

Second, decisions about where to locate production are only partially based on energy costs. The following are thought to be more influential factors:

- **Wages.** Access to relatively inexpensive labor was an attractive reason to locate production in emerging markets. But this advantage seems to be diminishing: wage costs are estimated to be rising very rapidly in places like China, Brazil and Mexico. Nonetheless, total employment costs in the United States remain higher than they are elsewhere.

- **Access to Raw Materials.** Minerals and metals account for the lion's share of manufacturing costs. Securing a steady supply and minimizing transit expenses are imperatives for efficient producers.

- **Proximity to Clients.** The simple truth is that some manufacturing has moved to emerging markets because the weight of demand growth has shifted away from mature economies.

- **Taxes.** Manufacturers in the United States face the highest rates of taxation among industrialized countries. Preferences for capital investment in manufacturing could be broadened to close this gap.

- **Regulation.** Everything from labor and environmental laws to the protection of property rights can enter into the equation when production siting is considered.

Given the long lead times involved, firms have to feel comfortable that any relative advantages across any of these dimensions are likely to persist. There are certainly anecdotes suggesting that producers are taking a longer look at U.S. facilities. There have been some highly publicized migrations, but a relatively small number of companies have actually made the shift.

For this groundswell to turn into a flood, America will need to take the right steps on the other criteria that operators are sensitive to. Until then, it will be hard for me to leave the Dark Ages and embrace the Renaissance.

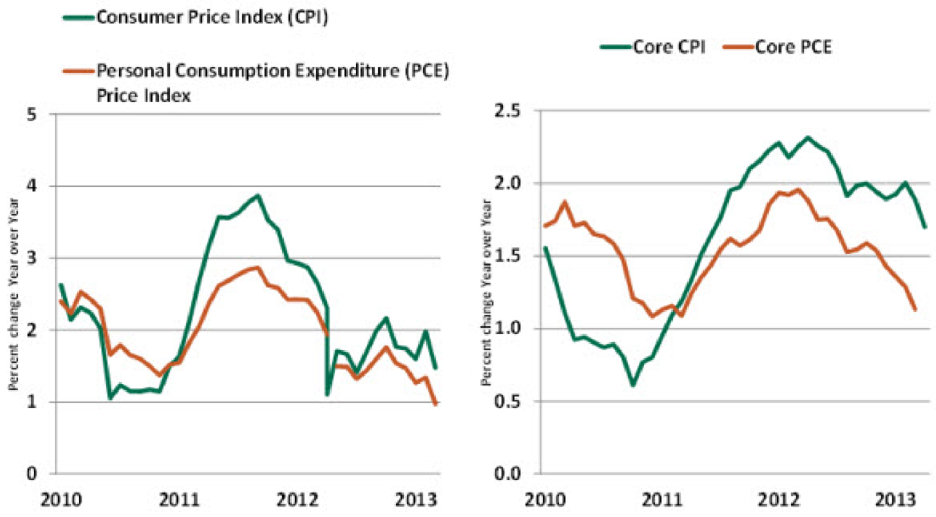
Inflation Loses Steam…Will It Stay Low?

For most of the past year, concern about central bank policy has been that too much ease will invite the risk of a rising price level. But in the United States, key measures of inflation are moving in the opposite direction. Will this complicate the conduct of monetary policy over the next few months?

The Federal Reserve's preferred measures of inflation – the personal consumption expenditure (PCE) price index and the core PCE, which excludes food and energy – have both trended down for the past six months, with the latest readings at 1.0% and 1.1%, respectively.

The well-known consumer price index (CPI) and the core CPI also show a decelerating trend. The April year-to-year change in the CPI and core CPI are 1.1% and 1.7%, respectively.

Should it persist, the accelerating disinflation could be cause for concern. The specter of deflation comes closer and it may prompt the Fed to act to avoid it. This issue may explain why the most recent Federal Open Market Committee minutes suggested that quantitative easing could be increased or decreased, depending on conditions.



Sources: BLS, BEA, Haver Analytics

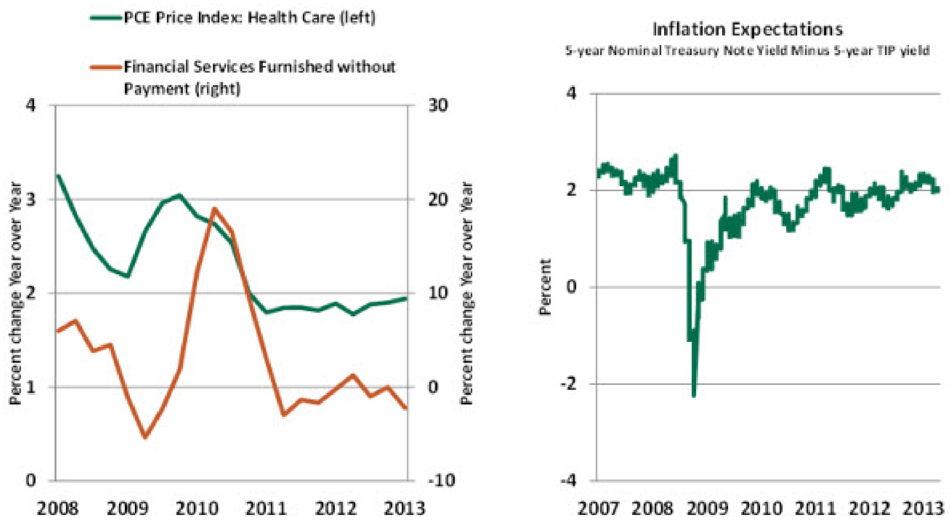
Why have core price indexes collapsed? Health care costs and financial services costs explain a large part of the recent downward trend of PCE core price measure. Additional elaboration is necessary here to fully appreciate the importance of both these factors. In health care, increases in the health care services price index peaked in late 2009 and have moved sideways since early 2011. The Centers for Medicare and Medicaid Services estimated that health expenditures rose around 3.9% during 2009-2011. These are impressive numbers because growth in health care expenditures averaged a 7.2% increase in the nine years ended 2008. Slower demand tends to dull the pressure on costs.

The key question is whether this trend will persist in the years ahead. There is a cautious optimism in the latest research findings about trends in health care expenses. One of the main findings is that the recent recession only partly explains the decline in health care expenditures. High-deductible plans, employer efforts to control costs, expiration of drug patents, reduction in the rate for introducing new technology, and Medicaid cost containment each played a role.

Going forward, the 30.9% reduction in Medicare payments to physicians and the 2.0% reduction in payments to providers under the sequester will contribute to containment of health care expenditures. While insurance coverage is likely to expand under the Affordable Care Act, competition among exchanges is another factor seen trimming costs. For now, however, the future course of health care costs is unclear.

Moving on to financial services costs, the price of "financial services furnished without payment" is one item in the PCE price index that is not in the CPI. This item represents services that do not have an explicit price, such as access to ATM machines and check writing. The Commerce Department uses complex computations to estimate this price.

The current low-interest-rate environment is driving down this price measure to the extent that it posted a significant 2.2% year-to-year drop in the first quarter and marks the seventh quarterly decline in the last eight quarters. The persistent reduction of this imputed price measure has accounted for part of the drop in the core PCE price measure.



Sources: Federal Reserve, BEA, Haver Analytics

Coming back to the decelerating trend of inflation, should the Fed consider raising the current pace of asset purchases to prevent deflation? The movement of health care costs and financial services are not representative of underlying economic fundamentals and are not durable trends. More importantly, inflation expectations are stable, and the momentum of the economy is not indicative of severely weak economic conditions and imminent deflation. The bottom line is that deflation is a very remote possibility, and the Fed's next move will likely be tapering – not increasing – asset purchases.

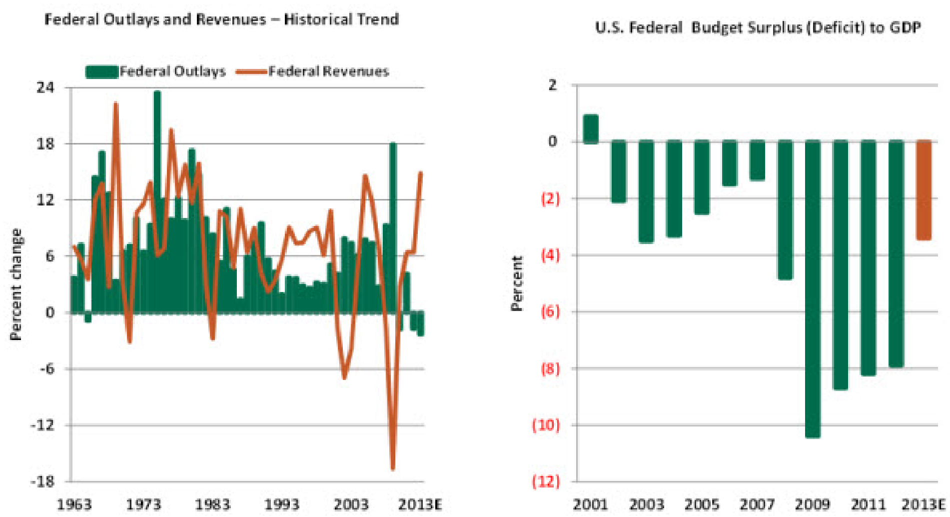
Fiscal Bounty

I've spent the past week working with partners here in Australia. The big business news during my visit was the release of the Australian budget, which garnered the sort of attention that is typically reserved for movie premiers and championship sports matches. It is impressive how attuned the citizenry "down under" is to fiscal matters.

In a nice coincidence of timing, I was able to share good budget news from the United States. The Congressional Budget Office (CBO) revised its estimate of the federal budget deficit for fiscal year 2013 to $642 billion, a $200-billion reduction from the February appraisal. If current law remains in place, the deficit will be 3.4% of the GDP versus 7.0% in 2012.

The improvement in the deficit reflects higher-than-expected revenues and special remittances from Fannie Mae and Freddie Mac. Federal government revenues rose 16% in the first seven months of the current fiscal year, while total outlays declined slightly (-0.6%) in the same period.

The CBO estimates a reduction in total federal outlays in 2013, the second consecutive annual decline and the first such event in several decades. Total revenues are now projected to show the fastest growth since 1981. This positive turn in the budgetary situation leads to noteworthy implications.



Source: Congressional Budget Office, Haver Analytics

Politically, the nature of budget negotiations should take a different tone because the urgency to rein in the federal budget deficit is reduced. The unexpected increase in revenue allows the Treasury to operate without raising the debt ceiling until probably October 2013, if it uses its usual extraordinary measures. This helps to avoid brinksmanship but may defer important conversations on long-term budget imperatives.

Australia's annual deficit is forecast to run about 2.5% of GDP, and its accumulated government debt sums to about 25% of GDP. While some here are concerned about that, I've tried to get them to recognize that things could be a whole lot worse.

www.northerntrust.com