In the wake of the recent recovery in manufacturing production, the capacity utilization rates published by the Federal Reserve Board (FRB) have rebounded much more slowly than those published by the Institute for Supply Management (ISM). As a result, some observers have speculated that the manufacturing sector may have considerably less slack than is indicated by the FRB measures. Our view is that the two characterizations of manufacturing slack are not as incongruent as they first appear. This paper discusses the practical and conceptual differences between these measures of capacity utilization, and concludes that the recent divergence simply reflects the character of the latest business cycle.

How much spare capacity is there in the overall manufacturing sector? The answer to this question is often thought to be a leading indicator of aggregate inflationary pressure and a signal of future industry capital spending. In 2004 and 2005, this question was brought into the spotlight when the utilization rates published by the Institute for Supply Management (ISM) in

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1See Morin and Stevens (2004) for a discussion of the predictive ability of the FRB measures of capacity utilization for industry capital spending, industry capacity expansion, and industry price changes.
Diverging Measures of Capacity Utilization: An Explanation

its Semiannual Economic Forecast diverged from those published by Federal Reserve Board (FRB) in its monthly G.17 Statistical Release, *Industrial Production and Capacity Utilization*. The upper panel of Figure 1 compares these two utilization rate measures; because the ISM rates generally run four to five percentage points above the FRB rates (for reasons discussed later), the lower panel shows the same series adjusted for the difference in their mean values over the November 1989 to April 2005 time period. As can be seen, a large gap appears to have opened recently. The FRB measure dropped almost nine percentage points during the most recent recession and, as of April 2005, remained about two percentage points below its 1972–2004 average of 79.8 percent. In contrast, while the ISM measure dropped by a similar amount in the recent downturn, it rebounded more quickly between the end of 2001 and early 2002. Most notably, it surged between November 2003 and April 2004, and eased back a bit in November 2004. The large gap between the ISM and FRB rates has persisted to April 2005, the most recent ISM release at the time this article was written.

Recent press articles have pointed to the sharp rise in the ISM rates as a signal of impending inflationary pressures within manufacturing that are being missed by the FRB operating rates. Many of these articles go on to argue that the FRB's measures remain too low because they fail both to reflect technology-induced obsolescence of older equipment and to remove idled plants from capacity that industries consider permanently closed. The *prima facie* case for the two measures painting different pictures of manufacturing slack appears to be persuasive and has intuitive appeal. However, as discussed below, the FRB and the Census Bureau exert substantial effort to ensure that closed plants and technological change are reflected in the published measures of utilization. Therefore, the explanation must lie elsewhere. Our view, like that expressed by Federal Reserve Board member Donald Kohn (2004), is that the two pictures of manufacturing slack are not as

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2The FRB and ISM are currently the only two organizations that publish aggregate capacity utilization rates for the United States manufacturing sector on a regular basis. The long-run trend in the FRB rates largely reflects the results of the Census Bureau's annual Survey of Plant Capacity (SPC), which is a survey of 17,000 manufacturing establishments that is jointly funded by the FRB and the Department of Defense.