REGIONAL HIGHLIGHTS

Federal Reserve Bank of Philadelphia

Second Quarter 2000

Region's Growth Shows Signs of Slowing

- *Job Growth Slows But Labor Markets Remain Tight*
- *Upward Pressure on Prices Continues*
- *Growth Is Expected to Slow in the Coming Months*

Although the tri-state region experienced relatively slow job growth in the second quarter, labor markets remain very tight. Local firms increasingly perceive inadequate labor supply as a constraint on production. Consistent with this perception, the region's unemployment rate has dipped below the nation's, despite a generally slower rate of job growth in the region than in the nation. The tight labor market, together with increases in materials and energy costs, is fueling increases in production costs and prices of final goods. There is increasing evidence, however, that the pace of growth in the region is slowing.

Several regional economic indicators point to slower demand in the near term. Local manufacturers reported a relatively sharp reduction in the rate of growth in June, and the retail, real estate, construction, and banking sectors are all showing a modest slowing in the rate of growth. Despite the signs of slowing, there is no evidence of increased slack in the labor market yet and little evidence of moderating input or output prices.

Despite Slow Job Growth, the Unemployment Rate Continues to Fall

Tri-state payroll employment growth slowed in the second quarter. Part of the reason for the slow growth may be a shortage in labor supply: the Federal Reserve Bank's Beige Book contacts, respondents to the bank's *Business Outlook Survey*, and the press have all noted the difficulties firms are having filling job vacancies. According to preliminary data, tri-state payroll employment was up 0.2 percent in the second quarter after growing 0.5 percent in the first quarter (**Figure 1**). Second-quarter job growth in the region significantly lagged the 0.7 percent growth (including census workers) registered in the nation. Of the 24,000 jobs added in the region during the second quarter, 16,500 were in the government sector. The service sector registered modest gains, but most other sectors were nearly flat. Jobs in the construction sector declined after strong growth in the first quarter.

The slowing tri-state employment growth is exclusively a consequence of a 0.1 percent drop in payroll employment in Pennsylvania in the second quarter; that drop followed strong growth of 0.7 percent in the first quarter. New Jersey and Delaware, on the other hand, registered healthy gains of 0.6 percent and 1.0 percent, respectively, in the second quarter, a bit stronger than in the first quarter. Despite Pennsylvania's weak job growth numbers, employment in the Philadelphia metropolitan area grew at a moderate rate of 0.3 percent.

Despite slow employment growth, even slower growth in the labor force resulted in a drop in the tri-state region's unemployment rate in the second quarter. The tri-state unemployment rate fell 0.1 percentage point, to 3.9 percent. It was 0.1 percentage point less than the nation's in both the first and second quarters. Typically the tri-state unemployment rate has exceeded the nation's throughout the 1990s.

Within the region, Pennsylvania's second-quarter unemployment rate fell from 4.0 to 3.9 percent; New Jersey's also fell 0.1 percentage point, from 3.9 percent to 3.8 percent; but Delaware's rate increased from 3.3 percent to 3.6 percent. New Jersey's unemployment rate is now nearly a full percentage point lower than it was in the second quarter of last year, but the rates in Pennsylvania and Delaware have fallen less over the last year. Local labor markets generally have low unemployment rates (**Figure 2**). Even Vineland and Atlantic City, where rates are typically very high, have experienced declining unemployment rates. Vineland's rate has fallen to 7.0 percent and Atlantic City's to 6.7 percent.

Upward Pressure on Prices Continues

The region, like the nation, has seen an acceleration in inflation this year. Signals are mixed, however, with respect to whether the upward price pressure is continuing to build.

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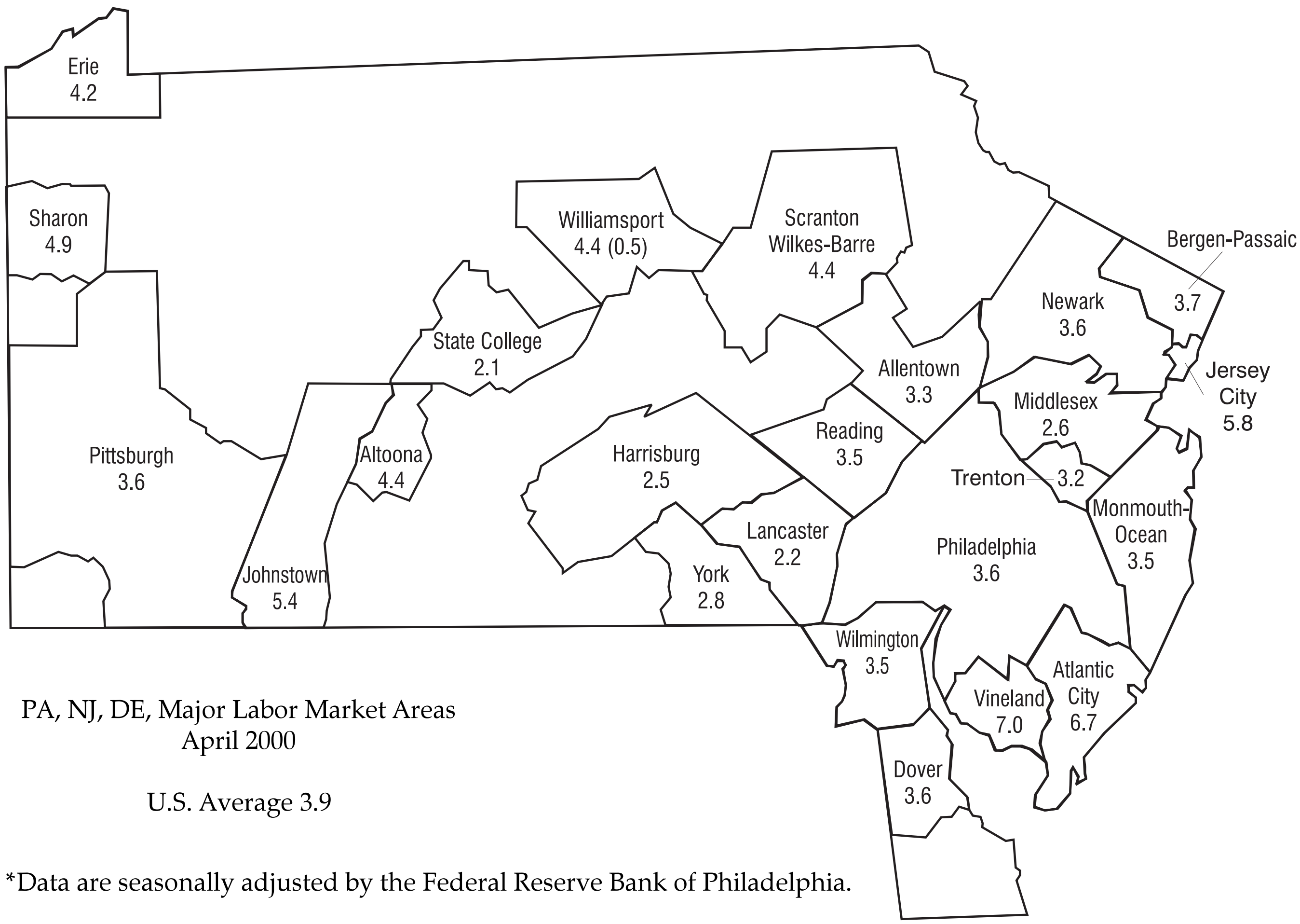
Figure 1
UNEMPLOYMENT RATES AND EMPLOYMENT GROWTH*
Seasonally Adjusted

	1999				2000	
	I	II	III	IV	I	II**
3-STATE TOTAL						
Unemployment Rate	4.5	4.5	4.5	4.3	4.0	3.9
Payroll Employment Growth	0.6	0.4	0.2	0.2	0.5	0.2
Resident Employment Growth	0.1	0.3	0.3	0.4	0.4	0.1
PENNSYLVANIA						
Unemployment Rate	4.5	4.4	4.4	4.2	4.0	3.9
Payroll Employment Growth	0.7	0.4	0.1	0.0	0.7	-0.1
Resident Employment Growth	0.5	0.3	0.1	0.1	0.4	-0.3
NEW JERSEY						
Unemployment Rate	4.6	4.7	4.7	4.4	3.9	3.8
Payroll Employment Growth	0.5	0.5	0.3	0.5	0.4	0.6
Resident Employment Growth	-0.2	0.4	0.5	0.7	0.3	0.5
DELAWARE						
Unemployment Rate	3.6	3.6	3.4	3.5	3.3	3.6
Payroll Employment Growth	1.0	0.5	0.5	1.0	0.6	1.0
Resident Employment Growth	-2.7	-0.4	0.6	1.6	1.3	1.4
PHILADELPHIA MSA						
Unemployment Rate	4.0	4.0	4.3	4.0	4.0	3.6
Payroll Employment Growth	0.5	0.4	0.2	0.4	0.9	0.3
Resident Employment Growth	0.5	0.5	-0.2	0.1	1.5	0.0
UNITED STATES						
Unemployment Rate	4.3	4.3	4.2	4.1	4.1	4.0
Payroll Employment Growth	0.7	0.5	0.5	0.6	0.6	0.7
Resident Employment Growth	0.7	0.1	0.2	0.5	0.8	0.0

* Employment growth is percent change from previous quarter.
** Based on April and May data. Philadelphia MSA resident employment based on April data only.

Figure 2
THREE-STATE UNEMPLOYMENT RATES*



PA, NJ, DE, Major Labor Market Areas
April 2000

U.S. Average 3.9

*Data are seasonally adjusted by the Federal Reserve Bank of Philadelphia.

The annualized rate of CPI inflation for the Philadelphia area during the first four months of the year was 4.2 percent, slightly lower than the nation's, which increased at a rate of 4.3 percent through April. Note that the Philadelphia CPI is now issued only six times a year; therefore, a reading for Philadelphia is not available for May.

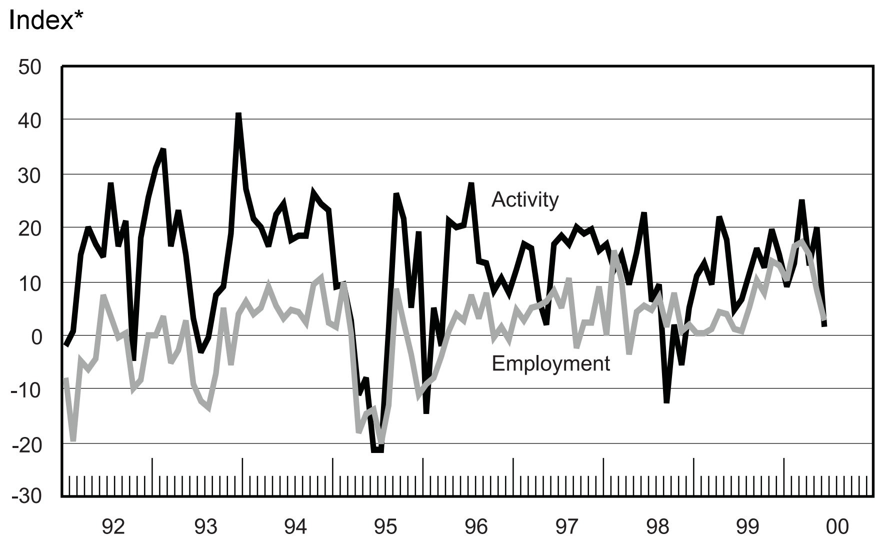
Wages and salaries in the Northeast increased 3.8 percent over the 12-month period ending in March. Although this increase was smaller than the national average increase of 4.2 percent, it was considerably higher than the 3.3 percent increase registered for the Northeast for the 12-month period ending in December. Compensation including benefits increased at an even faster clip, 4.1 percent. Again, this figure was considerably higher than the 3.4 percent measured for the 12-month period ending in December. However, it was considerably weaker than the national average of 4.6 percent.

Our most recent price data come from respondents to the Philadelphia Federal Reserve Bank's *Business Outlook Survey*, who continue to report significant upward pressure on prices, especially input prices. There are some modest signs, however, that upward pressure on manufacturing input prices may be moderating. The diffusion index for input prices, which measures the difference in the percentage of firms

Figure 3
BUSINESS OUTLOOK SURVEY
Current Prices

* Index represents percentage of respondents reporting an increase minus percentage reporting a decrease.

Figure 4
BUSINESS OUTLOOK SURVEY
Current Activity and Employment



* Index represents percentage of respondents reporting an increase minus percentage reporting a decrease.

experiencing increases in input prices and the percentage experiencing falling input prices, now stands at 30.8, indicating substantial upward pressure on input prices (**Figure 3**). The index has remained above 30 for five consecutive months. For comparison, the index was always less than 25 in the second half of last year, less than 15 in the first half of last year, and negative in much of 1998. Even though the input price readings are relatively high, they have declined modestly in each of the last four months, offering hope that input price pressures are moderating.

The index for the sale prices of manufactured goods has not reached levels nearly as high as those for the input price index. The diffusion index for prices received ticked upward from a reading of 7.7 in May to 10.5 in June. With the exception of an upward spike to 18.2 in April, this index has fluctuated in a relatively narrow range this year. Although this index has not reached the high levels of the input price index, it is fairly high relative to readings taken before the start of the year. The output price index was about zero from mid-1996 to mid-1998 and consistently negative from mid-1998 through mid-1999.

All Sectors Appear to Have Slowed in Second Quarter

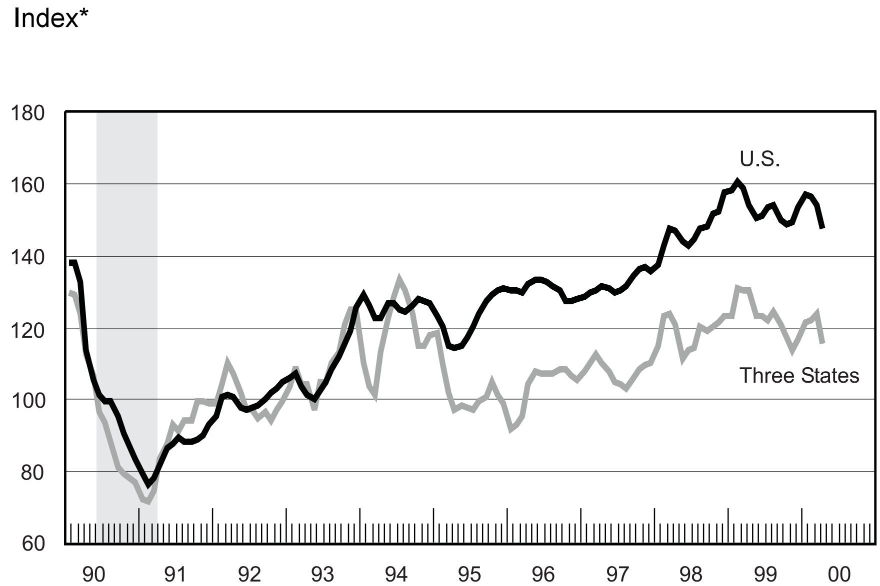
The manufacturing sector appears to have slowed late in the second quarter. The June *Business Outlook Survey* shows a sharp drop in growth after relatively strong readings in previous months. The drop in June, however, represents only a single month's reading, and whether the weakness will persist is an open question.

The *Business Outlook Survey's* main index of current economic activity fell sharply from 20.2 in May to 1.7 in June, indicating that the percentage of firms reporting increases in activity exceeded the percentage reporting declines by only 1.7 percentage points (**Figure 4**). Firms producing durable goods generally reported stronger activity than those in the nondurables sector. Among the reasons given for the slowing rate of growth were high interest rates and a strong dollar. In addition to the survey's general activity index, virtually all other *Business Outlook Survey* indicators also point to a slowing manufacturing sector. In the June survey, indexes for new orders, shipments, unfilled orders, and delivery times all fell substantially. The employment index fell only modestly, but the index for length of the workweek fell sharply.

Bureau of Labor Statistics (BLS) employment data indicate that manufacturing employment in the tri-state area resumed its long-term downward trend after a brief respite in the first quarter. BLS data indicate that tri-state manufacturing employment declined by 2000 jobs in the second quarter. For the first five months of the year, manufacturing employment in the tri-state area was down by 10,000 jobs compared with the same period in the previous year. Despite these losses, the rates of decline in manufacturing jobs in the region have moderated in the last year.

Both residential and nonresidential construction, which rose sharply in the first quarter, remained at a very high level in the second quarter. There are, however, clear signs of slowing in both sectors. Issuance of housing permits has declined from the first quarter and is now considerably lower than the average rate of issuance that prevailed last year (**Figure 5**).

Figure 5
HOUSING PERMITS



* 1992=100

Housing units authorized by building permits; based on a three-month moving average.

The value of residential contracts in the three-state area also fell from its first-quarter peak, although it remains relatively high. The cumulative value for the first five months of this year is running 6.7 percent above last year's very strong numbers, suggesting that some of the decline in the second quarter may reflect an adjustment from the high levels of contracts in the first quarter because of the mild weather. Residential contracts were strongest in Pennsylvania, increasing 9.3 percent in the first five months over the same period last year, while Delaware's contracts increased 8.6 percent, and New Jersey's increased 3.5 percent. The Philadelphia metropolitan area experienced very rapid growth in contract values, 25.6 percent. The fact that the increase in the value of residential construction contracts appears to be somewhat stronger than the pace of permits is consistent with industry reports of healthy order backlogs for new houses. As this backlog is reduced, we may see additional slowing in the industry as a result of higher interest rates.

Tri-state nonresidential construction, as reflected in the value of new contracts, rose sharply in the first four months of the year but retreated considerably in May. Compared with the same period last year, construction contracts in the tri-state area fell 2.6 percent in the first five months of 2000. The tri-state decline was slightly smaller than the national decline of 4.0 percent. In New Jersey nonresidential contracts fell 11.8 percent, and Pennsylvania managed a small gain of 2.2 percent. Contracts in Delaware increased 72 percent, but because Delaware's nonresidential construction industry is so small, individual projects can have large effects on the numbers. Even though there has been some second-quarter slowing in the nonresidential construction sector, the office market appears to be relatively tight with rental rates rising in both city and suburban markets. Tight office markets and rising rental rates could spur additional construction; however, this incentive to build may be offset by rising financing costs associated with the recent increases in interest rates.

Taking the residential and nonresidential construction sectors together, the second-quarter slowing has resulted in a drop of 0.6 percentage point in second-quarter construction employment. This drop, however, followed very rapid growth of 2.8 percent in the first quarter so overall construction employment remains relatively strong. The construction industry has averaged 13,600 more jobs in the first five months of the year compared with the same period last year. Again, this suggests that the second-quarter decline may, in part, reflect an adjustment from the very strong first quarter that benefited from mild weather.

Retail sales in the region have moderated. According to the Federal Reserve System's Beige Book, retail sales growth in the region was minimal in May, and several retail contacts cited bad weather as the culprit. Auto sales in the region appeared to slow somewhat at the end of May; dealers indicated that a shortage of popular models hurt sales, and they are expecting healthy sales growth in the second half of the year. Consistent with second-quarter slowing, employment in the retail trade sector was flat, following 0.6 percent growth in the first quarter. Even though the second quarter was flat, employment in the retail trade sector increased by 29,600 jobs in the first five months of the year compared with the same period last year.

Area banks report slow growth in loans. Commercial loan demand has weakened as businesses have scaled back expansion plans. Consumer lending continues to grow, but some bankers report that the pace of consumer loan growth has slowed. Applications for mortgages have dropped, reflecting higher interest rates. Banks seem to be expecting relatively slow loan growth for the second half of the year.

Region Will Continue to Grow, But at Slower Pace

The outlook for the region's economy is for somewhat slower growth than last year, and forecasted growth is a little slower than that expected for the nation. Time-series forecasts suggest that from the first quarter of 2000 to the first quarter of 2001, payroll employment will grow at a relatively slow rate of 0.7 percent in Pennsylvania, 1.2 percent in New Jersey, and 1.9 percent in Delaware. These forecasted employment growth rates are lower than the previous year's growth. Even with relatively slow job growth, unemployment rates are projected to remain near their current levels. By the first quarter of 2001, Pennsylvania's unemployment rate is expected to be 4.1 percent, New Jersey's 4.0 percent, and Delaware's 3.5 percent. Real personal income is expected to grow nearly at the rates achieved last year. Finally, residential construction, as reflected in our permit forecast, is expected to slow. Permits are forecast to fall 14.2 percent in New Jersey, 12.0 percent in Pennsylvania, and 11.1 percent in Delaware.

Even though there is ample evidence of a recent slowing in growth and our time-series model is forecasting slower growth, other forward-looking indicators are not necessarily consistent with slowing future growth. The *Business Outlook Survey's* index of future activity turned up in June, in contrast with the decline in the current activity index. Initial unemployment claims, which tend to rise when the economy begins to slow, have been falling in recent months. Finally, our leading index for New Jersey remains very strong, arguing against slowing in the New Jersey economy. The Pennsylvania index, on the other hand, is consistent with future slowing. Despite turning upward in April, Pennsylvania's leading index remains at a relatively low level. More information is needed before we can determine whether the modest slowdown in the second quarter is just a pause before more rapid growth or whether forecasts of a sustained slower rate of growth in the economy are correct.

Richard Voith

Federal Reserve Bank of Philadelphia
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