



REGIONAL HIGHLIGHTS

Second Quarter 2002

Recent Gains Indicate Modest Improvement

The signs of recovery in the region's economy that were visible in the first quarter carried over into the second. Housing continues to be strong, with demand for both new and existing homes persisting and even growing. Manufacturing, the most cyclically sensitive sector of the region's economy, showed further strength in the second quarter. Consumer spending, although not expanding vigorously, was on a generally positive track in the second quarter except for motor vehicle sales, which have slipped from high levels in the fourth quarter of 2001 and the first quarter of this year. The weak spot continues to be commercial real estate markets, as vacancy rates have edged up. Employment also remains disappointing. Preliminary data suggest a slight gain in jobs in Delaware during the second quarter but continuing weakness in Pennsylvania and New Jersey.

The outlook is positive, but expectations for improvement are modest. Manufacturers anticipate further gains in the second half of the year. Retailers are looking for a slight acceleration in the growth rate of general merchandise sales through the rest of the year, although auto dealers anticipate only steady sales. Residential real estate conditions are difficult to forecast. Builders have backlogs that should keep them busy through the rest of this year, at least, but real estate agents anticipate some slowing in sales of both new and existing homes. Employment is forecast to improve slowly in each of the three states in the region as long as the recovery in the economy remains on track.

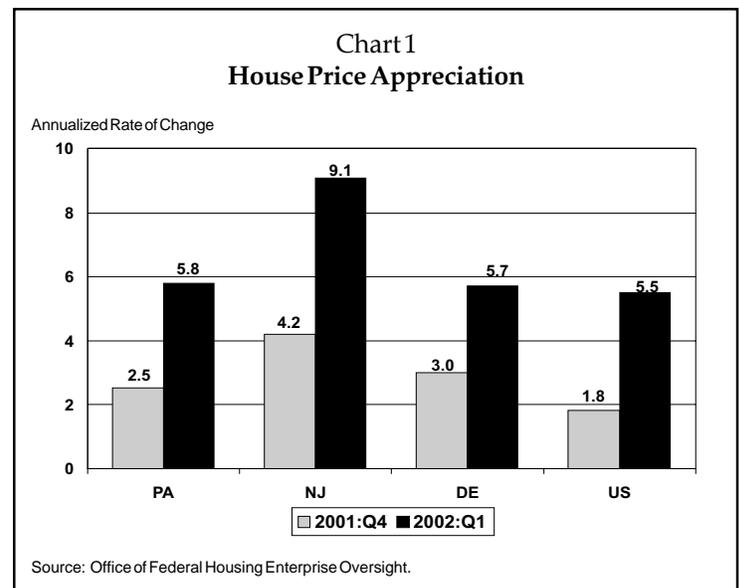
Demand for Housing Remains Strong

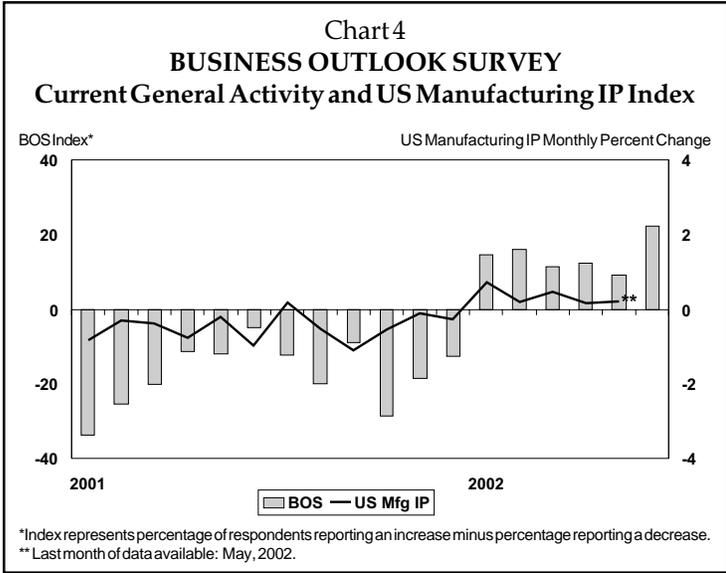
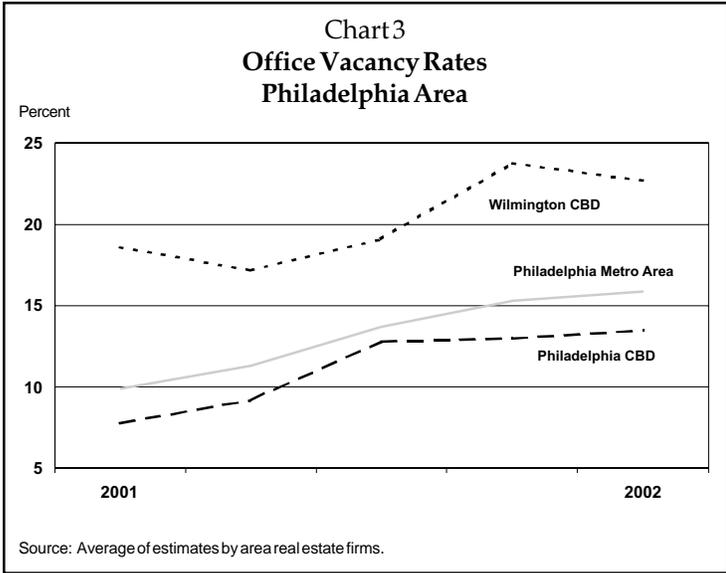
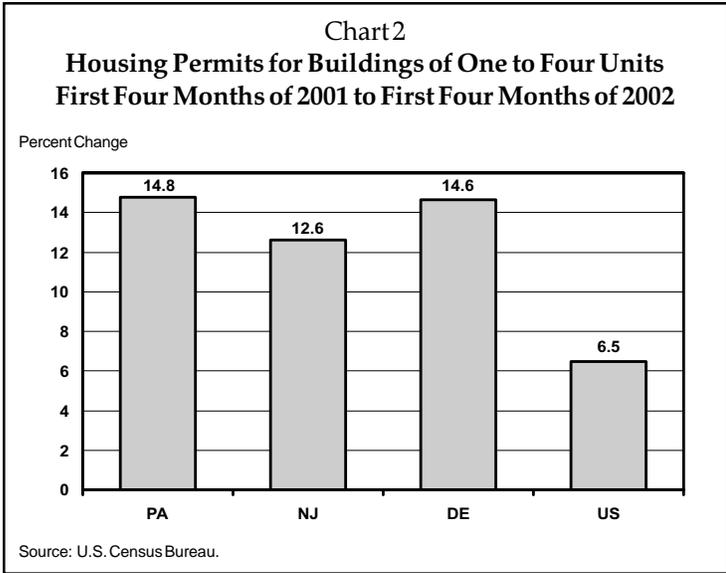
Home buying continues at a brisk pace in the region, as it does in most areas of the country. Sales of existing homes rose during the first quarter in the three states of the region, and the high rate of sales appeared to be continuing through the second quarter, according to the area's residential real estate agents. Low mortgage interest rates continue to underpin strong demand for homes. Existing homes for sale are receiving multiple bids in many parts of the region, and the average time homes are on the market before being sold has been decreasing. With strong demand, house prices have been rising. Price appreciation picked up in the first quarter of this year compared with the fourth quarter of last year in the three states

(Chart 1). Recently, real estate agents have observed appreciation rates for existing homes rising to double digits in some parts of the region, a rate of appreciation not seen since the broad rise in house prices in the 1980s.

Homebuilders report strong interest in new homes, with some new subdivisions selling out quickly. Permits issued during the first four months of this year for new residential structures with one to four units are up strongly from the same period a year ago in all three states (Chart 2). The percentage increase in each state exceeded the national increase. Not surprisingly, prices of new homes have been increasing about in line with prices of existing homes. Builders and real estate agents report a fair amount of move-up buying as well as strong demand for first-time homes and second homes in the region's vacation areas.

As home prices rise in the region and throughout the country, concern has grown that a price bubble is developing, with the potential for a swift collapse in residential real estate values. A





recent analysis by the Office of Federal Housing Enterprise Oversight (OFHEO) examined this possibility. According to OFHEO, the recent run-up in house prices appears to be similar to periods of rapid price appreciation in the 1970s and 1980s that were followed by periods of price decline, but there is a difference. Those earlier periods of price decline got under way when the national economy was on a downward trend. In contrast, the current rise in house prices has continued through a time of overall economic softness that appears to be coming to an end. If the economy is, in fact, on the rebound, OFHEO expects any decline in house prices that occurs to be less marked than in previous declines that began during recessions.

Commercial Real Estate Lags

Commercial real estate markets in the region have eased since winter (Chart 3). According to recent surveys by commercial real estate firms, the overall office vacancy rate (including sublease space available) in Philadelphia’s central business district has edged up since the beginning of year and now stands at around 14 percent. Rental rates have declined slightly. The overall vacancy rate in Wilmington’s central business district has improved marginally, but it is still high—over 20 percent. Rental rates in Wilmington have been steady. Overall vacancy rates have increased more in the region’s suburban office markets, where recently completed buildings have added to available space. The average overall vacancy rate among the major suburban markets is around 16 percent, but rates vary from place to place. Within the greater Philadelphia metropolitan area, overall vacancy rates are higher in some of the Pennsylvania suburbs and lower in some of the New Jersey suburbs. For the region as a whole, and particularly in the suburbs, relatively large amounts of office space continue to be on the market for sublease, and this is exerting downward pressure on effective rents.

Despite the subdued demand for office space, there is a fair amount of nonresidential construction activity in the three-state region. In recent months new casino development contracts have been announced in Atlantic City. Other significant construction projects include highway construction, health care facilities, schools, and electric power plants. Plans for several new office buildings in Philadelphia have been announced recently, although construction has not started. Target completion dates for these buildings are within the next five years.

Manufacturing Continues to Improve

The upturn in regional manufacturing activity in the region that began in January has continued into the second quarter. The Philadelphia Fed’s *Business Outlook Survey* of manufacturing firms has recorded gains in each month so far this year. June’s reading of the current general activity index, 22.2, was the highest since June 1998. The upturn in manufacturing in the region parallels a national rebound in manufacturing (Chart 4). Manufacturers responding to the survey have been reporting increases in new orders each month since January, and the current new orders index also rose to its highest level so far this year in June (Chart 5).

A key element of expanding economic activity will be spending by businesses for new plants and equipment. The capital spending

plans of manufacturers in the region call for increases in the second half of the year, on balance (Chart 6). Manufacturers participating in the June *Business Outlook Survey* were asked about their plans for spending on technology items, a major portion of total capital spending in recent years. Sixty-eight percent of the firms indicated they will maintain steady technology budgets for the remainder of this year, 19 percent will increase technology spending, and 13 percent will trim technology spending. This is a positive sign, but it implies only modest gains, overall, in the second half of the year.

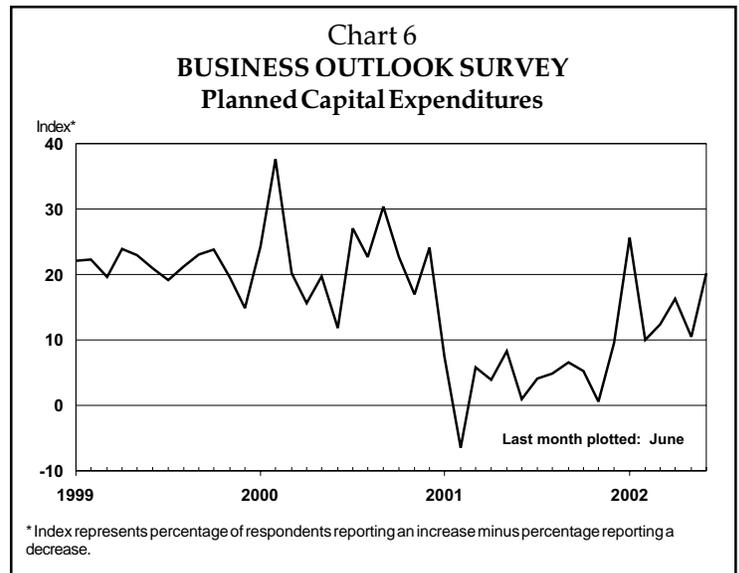
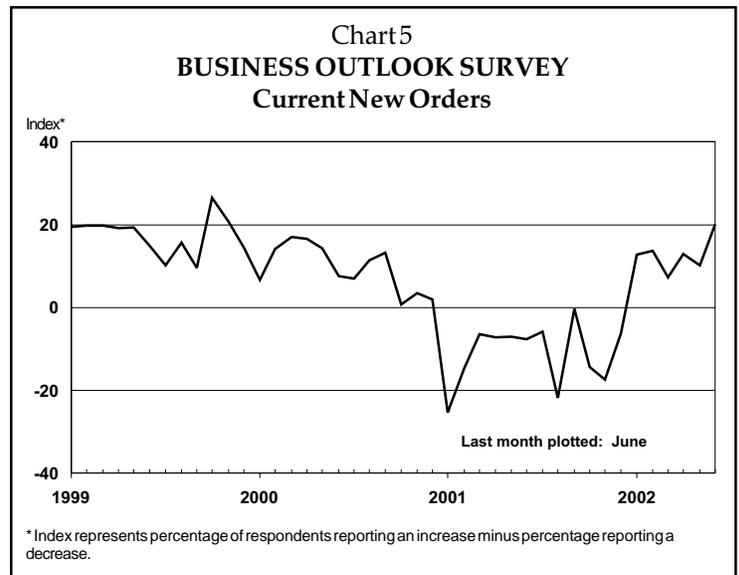
Consumer Spending Holds Up

Retail sales of general merchandise have been rising modestly, according to store executives in the region. Sales of summer apparel and other seasonal items were delayed during much of May by unseasonably cool weather, but a return to more normal temperatures late in May and June appears to have stimulated consumer buying. Consumer spending in the region has also gotten a recent boost from the start of the vacation travel season, increased movie theater attendance, and a pickup in restaurant dining. Auto sales have eased in the region, as they have throughout the nation, since the end of last year. Nevertheless, auto sales were fairly strong in most parts of the region during the second quarter. Retail store executives expect some improvement in the growth rate of general merchandise sales during the second half of the year. Auto dealers expect sales to remain close to the current rate.

Employment Trend Is Still Weak

Employment trends in the three states of the region have shown little change recently. Preliminary data for the second quarter indicate that employment edged down in Pennsylvania and New Jersey and rose fractionally in Delaware. (See Table 1 on page 4.) The quarterly unemployment rate increased in New Jersey and Delaware and was unchanged in Pennsylvania. Each state's unemployment rate remains below the national rate.

On a monthly basis, employment in the nation increased marginally in April and May. Although the increases were very small, they marked the first monthly gains in employment since the onset of the recession in March 2001. In the three states of the region, changes in employment were mixed in April and May. Pennsylvania had a decline in April and an increase in May. New Jersey had decreases in each month. Delaware had a decline in April and an increase in May. A few months of data on employment are too little to discern a break in the trend, especially at the state level where month-by-month employment readings are very variable. But if the apparent bottoming out in national employment portends the start of an improvement in employment conditions, some increases in employment in the three states of the region should follow fairly quickly. In the last four recessions, the upturn in the three states has come relatively soon after the national rebound. Delaware employment turned up around the same time as employment in the nation, just as it seems to have done recently. The upturn in New Jersey has followed the national upturn by approximately one month, on average. Employment in Pennsylvania has been slower to pick up; on average, employment in the state began to increase around three months after the national recovery got under way following the last four recessions.



Recent data indicating that the national economy is beginning to pick up (GDP increased in the last two quarters) and that the regional economy has some elements of strength, such as the housing sector, are giving a slight boost to our regional economic forecast. Our forecast model predicts growth in employment in each of the three states from the first quarter of this year to the first quarter of next year. The model forecasts declines in unemployment rates in Pennsylvania and Delaware after the current quarter and a steady rate in New Jersey through the first quarter of 2003. (See Table 2 on page 4.)

Timothy Schiller
Senior Economic Analyst

Shannon Mail
Research Associate

Table 1
Unemployment Rates and Employment Growth*
Seasonally Adjusted

	2001				2002	
	I	II	III	IV	I	II**
3-STATE TOTAL						
Unemployment Rate	4.1	4.4	4.5	4.9	5.4	5.5
Payroll Employment Growth	0.2	0.0	-0.2	-0.3	-0.2	-0.2
PENNSYLVANIA						
Unemployment Rate	4.5	4.6	4.8	5.0	5.6	5.6
Payroll Employment Growth	0.2	-0.1	-0.1	-0.7	-0.2	-0.2
NEW JERSEY						
Unemployment Rate	3.6	4.1	4.3	4.8	5.2	5.5
Payroll Employment Growth	0.3	0.1	-0.4	0.1	-0.1	-0.2
DELAWARE						
Unemployment Rate	3.9	3.4	3.3	3.3	3.7	4.2
Payroll Employment Growth	0.0	0.0	-0.7	0.0	-0.6	0.1
UNITED STATES						
Unemployment Rate	4.2	4.5	4.8	5.6	5.6	5.9
Payroll Employment Growth	0.1	-0.2	-0.2	-0.6	-0.3	0.0

* Percent change from previous quarter.

** Based on two months of data.

Table 2
Employment Growth and Unemployment Rate Forecasts

	PA	NJ	DE
Job Growth (2002:I to 2003:I)	0.9%	1.1%	1.4%
Unemployment Rate 2003:I	5.4%	5.5%	4.0%