



REGIONAL HIGHLIGHTS

Fourth Quarter 2003

Economic Activity Picks Up, But Employment Growth Is Slight

Business conditions in the region improved in the fourth quarter, but employment increased only slightly. The manufacturing sector's recovery strengthened. Consumer spending rose, with a year-over-year increase in sales for the Christmas shopping period and a continuing high rate of auto sales. Housing remained robust as home sales and construction continued on an upward trend. However, commercial real estate markets were still slack. Employment in the three states of the region has begun to edge up, although the improvement in labor market conditions has been slight. The outlook is for continued moderate expansion of business activity in the region during 2004 and better, though still modest, growth in employment.

Manufacturing Activity Expands

The region's manufacturing sector was expanding as 2003 came to a close. Manufacturing firms participating in the Philadelphia Fed's *Business Outlook Survey* have reported advances in activity for each of the past seven months (Chart 1). The survey's general activity index reached 30.3 in December, the highest reading in 10 years. The number of firms reporting gains in shipments and new orders exceeded the number of firms experiencing declines in these measures by a wider margin in December than in any previous month of the year (Chart 2).

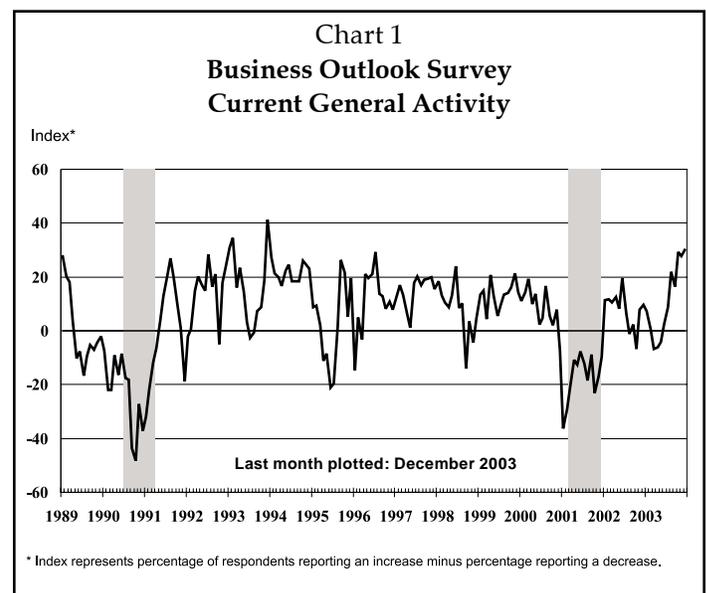
The manufacturers participating in the survey continued to extend working hours in the fourth quarter, following a trend that began in the third quarter, and more firms hired workers than laid off workers. These developments suggest that the region's manufacturers expect better conditions to persist. And, in fact, order backlogs rose in December, indicating that demand for the products of local industrial companies has risen solidly.

With encouraging recent developments, area manufacturers are optimistic that further improvement is ahead. More than half expect increases in orders and shipments during the first half of 2004, and only a few expect decreases. A more widespread and consistent recovery in the region's manufacturing sector

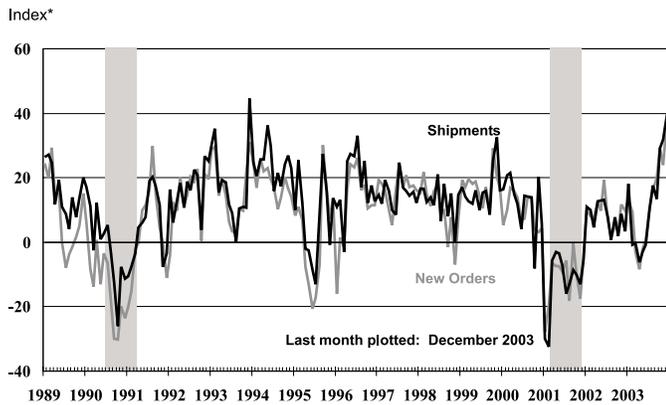
is likely to prompt some stepped-up investment at area plants. Capital spending by survey participants has fluctuated since the recession ended in November 2001. However, the index of capital expenditure plans from the Philadelphia Fed survey increased during the fourth quarter, and in December it rose close to the levels usually recorded during economic expansions (Chart 3).

Consumer Spending Gains Strength

Retailers in the region generally posted increased sales during the important year-end shopping period. Although weekend snowstorms in December limited early holiday shopping, strong buying in the week before and the week after Christmas lifted most stores' results to meet or exceed merchants' expectations. Weather was also a factor earlier in the fourth quarter, when unseasonably warm temperatures delayed sales of outerwear and other fall merchandise. For the quarter as a whole, though, it appears that consumer expenditures rose



**Chart 2
Business Outlook Survey
Current New Orders and Shipments**

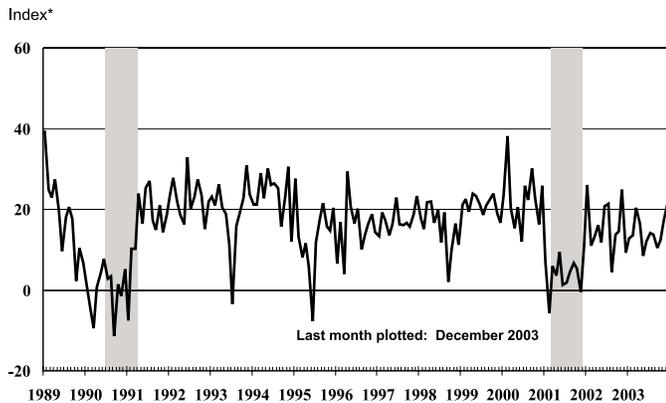


* Index represents percentage of respondents reporting an increase minus percentage reporting a decrease.

more strongly, on a year-over-year basis, than they did in the first three quarters of the year. National measures of consumer confidence showed a rise as winter began, and the national increase in Christmas sales was further evidence of growing consumer optimism. In the region, merchants cited increases in purchases of luxury items and higher-priced, higher-quality goods as a sign that consumers are feeling more confident about economic conditions. Retailers reported that sales during the fourth quarter continued to be relatively strong for furniture, home furnishings, and items related to home improvement and remodeling. Sales of women's apparel continued to be relatively weak, hampered by the lack of new fashion trends as well as the unseasonable weather in the fall.

Auto sales in the region in the fourth quarter were roughly equal to sales in the same period a year ago. Manufacturers' incentives continued to support a good sales rate, and the introduction of new models in the fall stimulated buying as well. Auto dealers expect sales to continue to run at a fairly high rate in 2004.

**Chart 3
Business Outlook Survey
Future Capital Spending**



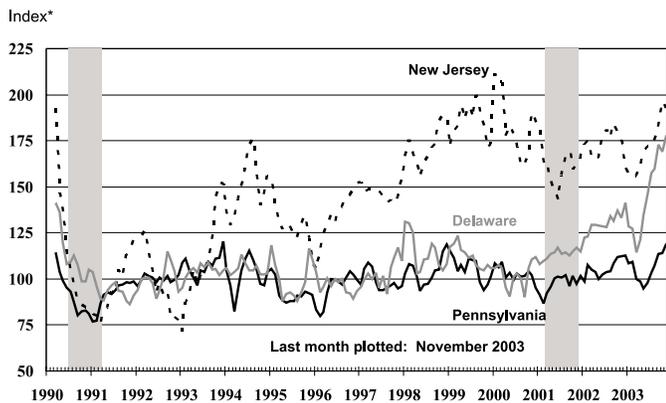
* Index represents percentage of respondents reporting an increase minus percentage reporting a decrease.

Residential Real Estate Remains Strong

The residential real estate sector remains active in the region, as it does throughout the nation. For the three states as a whole, sales of new and existing homes rose in the fourth quarter. Housing permits have risen in all three states of the region (Chart 4). Homebuilders and real estate agents generally expect the pace of sales to continue near its current rate into next year. They believe an improving economy will support a high sales rate even if mortgage interest rates begin to move up.

Homebuilders and real estate agents indicated that prices of both new and existing homes rose steadily during the fourth quarter. Some builders noted that the percentage of buyers who order upgraded features in new homes has been increasing. The latest data (third quarter) from the Office of Federal Housing Enterprise Oversight (OFHEO) indicate year-over-year home price increases of 6 percent in Pennsylvania, nearly 8 percent in Delaware, and more than 8 percent in New Jersey (Chart 5). Price appreciation in all three states exceeded the national rate during the quarter and for the year-over-year period. In the region as well as in the nation, the trend of price appreciation has been easing, although it remained fairly high by historical standards in the third quarter.

**Chart 4
Total Housing Permits**



*1992=100
Based on a three-month moving average.

Commercial Real Estate Markets Remain Slack

Conditions in the region's office markets have shown little change in recent months. The vacancy rate in the Philadelphia central business district has been practically steady at approximately 11 percent, but the vacancy rate rose in suburban markets in the third quarter (Chart 6). For suburban markets as a whole the vacancy rate is estimated at 17 percent, up around 3 percentage points since mid-year. The increase was mainly the result of a large corporation's relocating to a new building, putting its former space on the market. Vacancy rates in suburban office markets are not expected to decline anytime soon because several large buildings currently under construction are nearly finished and will add to the region's available office space. For 2004, vacancy rates in the region as a whole are expected to decline slightly.

Throughout the region, average asking lease rates have edged down, and effective rental rates have continued to decline as landlords offer generous tenant improvement allowances, especially for firms that lease relatively large amounts of space. Several large leases will come due for renewal in 2004 and 2005. Lease agreements for an office tower to be built in Philadelphia were announced at the end of the year, and negotiations for either renewed leases or leases in new locations are expected to be active in 2004. Most recent lease deals have been by companies already established in the region taking the same or less space, and these have been at level or lower rents. If new companies locate in the region or local companies begin to expand, there could be an increased demand for office space and rents could stabilize or turn up.

Employment Grows Slowly

Employment edged up in the region in the fourth quarter (see Table 1 on page 4). Employment in the region and in the nation has been recovering slowly and unevenly in the past two quarters, following a protracted decline that extended beyond the officially designated trough of the recession, at the end of 2001, to the middle of 2003. For the nation as a whole, employment has still not returned to the level to which it fell at the recession's trough, and among the three states in the region employment has surpassed the trough level only in New Jersey (Chart 7).

The relatively stronger growth in employment in New Jersey compared with the nation and with the other states in the region can be attributed to stronger job growth in the state's service industries, especially health and education services, and in government. All service sectors in New Jersey have not had job gains, however. Employment has fallen much more steeply in the information services sector in the state than it has in the nation. This sector includes publishing, broadcasting, telecommunications, and Internet services, which had substantial declines in activity during the recession and have been improving only weakly since it ended.

Modest Growth on the Horizon

Area business firms expect business conditions to improve steadily, though modestly, in 2004. Manufacturers expect the current recovery in that sector to gather momentum as the year advances. Retailers expect sales to rise slowly during the year. Service companies also anticipate some increases in activity. Residential building is likely to remain strong, but commercial real estate markets are expected to firm up only very gradually as overall business activity and hiring increase in the region. The Philadelphia Fed's forecasting model for employment projects a strengthening in employment growth in the three states during the year and declines in unemployment rates (see Table 2).

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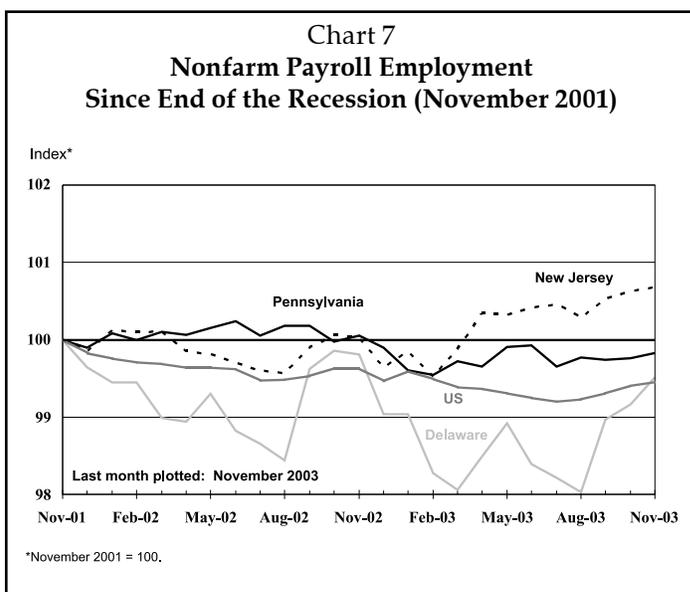
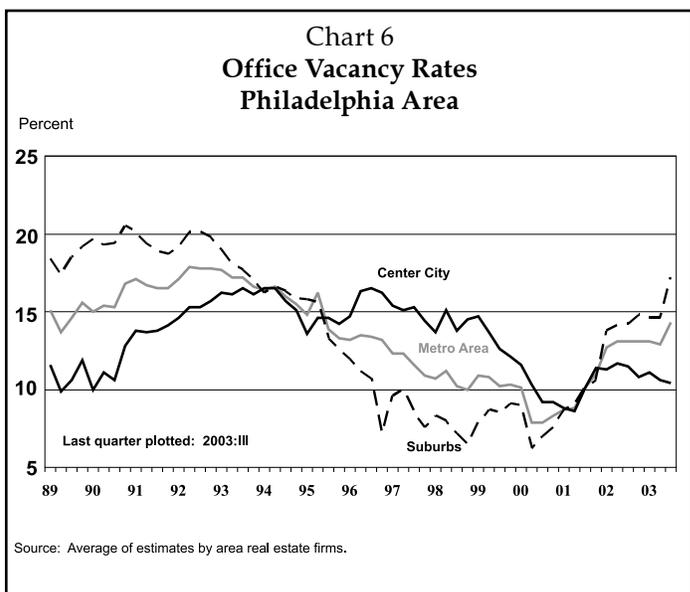
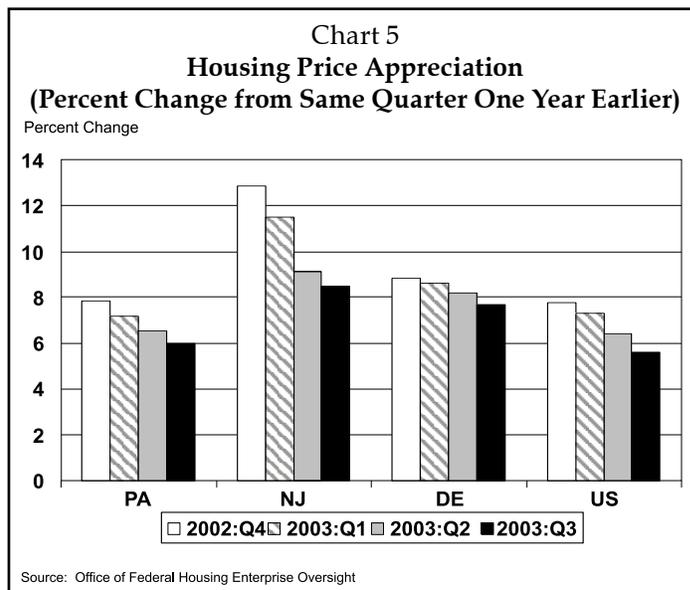


Table 1
Unemployment Rates and Employment Growth*
Seasonally Adjusted

	2002		2003			
	III	IV	I	II	III	IV**
3-STATE TOTAL						
Unemployment Rate	5.7	5.9	5.8	5.7	5.6	5.4
Payroll Employment Growth	-0.1	0.0	-0.3	0.4	0.0	0.2
PENNSYLVANIA						
Unemployment Rate	5.7	5.9	6.0	5.7	5.4	5.3
Payroll Employment Growth	0.0	-0.2	-0.4	0.2	-0.1	0.1
NEW JERSEY						
Unemployment Rate	6.0	6.0	5.7	5.7	5.9	5.6
Payroll Employment Growth	-0.1	0.2	-0.1	0.6	0.1	0.2
DELAWARE						
Unemployment Rate	4.3	4.3	3.7	3.9	4.4	4.1
Payroll Employment Growth	-0.1	0.7	-1.1	0.1	-0.2	1.0
UNITED STATES						
Unemployment Rate	5.8	5.9	5.8	6.2	6.1	6.0
Payroll Employment Growth	-0.1	0.1	-0.1	-0.2	-0.1	0.2

* Percent change from previous quarter.

** Fourth quarter numbers reflect two months of data.

Table 2
Regional Forecast

	Forecast			Actual		
	2003:III - 2004:III			2002:III - 2003:III		
	PA	NJ	DE	PA	NJ	DE
Employment	1.6	1.6	1.5	-0.4	0.7	-0.5
Unemployment Rate*	5.1	5.5	4.0	5.4	5.9	4.4

* Unemployment rate forecasts represent the expected unemployment rate in 2004:III, while the actual unemployment rate represents 2003:III