REGIONAL HIGHLIGHTS

Third Quarter 2002

Slow Recovery Continues

The improvement in business activity in the region that was building in the first half of the year appeared to slow somewhat in the third quarter. Manufacturers reported some fluctuation in shipments and orders during the quarter, although the trend is still modestly upward. Retail sales of general merchandise declined during the quarter despite the seasonal buying of school-related items in August and September. In contrast, auto sales remained robust. Commercial real estate markets continued to ease. Home sales have slipped since spring, although they continue at a fairly strong pace. A small, positive development in the third quarter is an apparent easing in the downward path of employment.

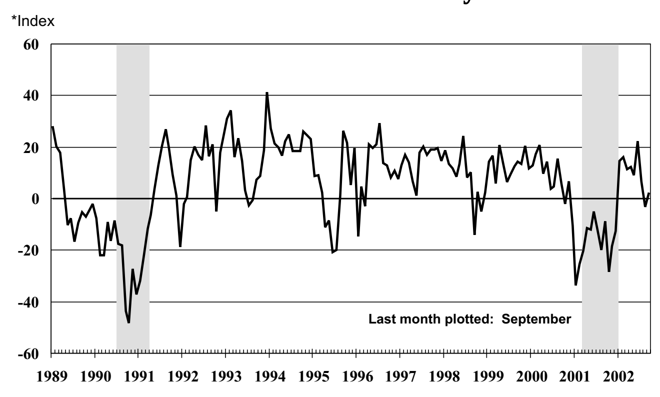
The outlook in the region's business community remains positive, but uncertainty about the strength of the recovery has increased. In most sectors, only steady or slowly growing activity is forecast. Our employment projections call for job increases in each of the three states in the region but little change in unemployment rates.

Manufacturing Expansion Slows

The expansion in manufacturing activity in the region that began in January slowed as the third quarter came to an end. The overall measure of manufacturing conditions in the Philadelphia Fed's *Business Outlook Survey*—the current general activity index—dipped slightly into negative territory in August after a seven-month string of positive readings. In September the index rebounded to a slight positive number (Chart 1). Both months' readings were close to zero, indicating little recent change in the pace of manufacturing activity. Specific measures of demand and output in the region's manufacturing sector have traced similar paths. New orders and shipments fell in August after increasing during the first seven months of the year; they increased slightly in September (Chart 2). Manufacturing activity in the region has paralleled national industrial production this year, turning up in January, continuing to expand through the first half, and easing in the summer.

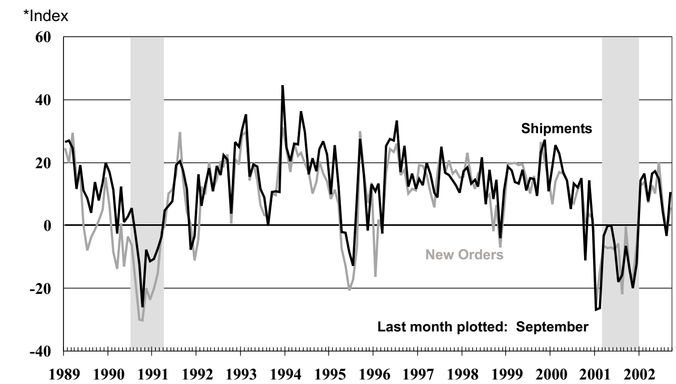
Although growth in manufacturing has evidently slowed, the general trend remains upward, as reflected in the new orders and shipments indicators, and most of the manufacturers participating in the survey expect the advance to continue. The future general activity index has been positive for more than a year, and the latest reading indicates that firms participating in the survey remain optimistic in their six-month-ahead forecasts for the region's manufacturing sector (Chart 3). On balance, firms surveyed in September expect increases in new orders and shipments, and they plan to increase capital spending but not by a large amount.

Chart 1
Business Outlook Survey
Current General Activity



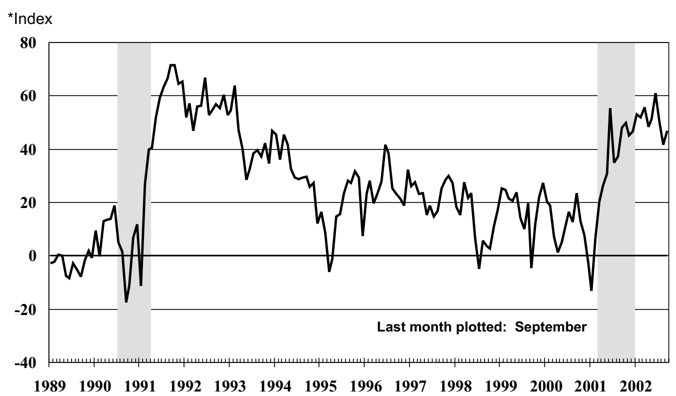
* Index represents percentage of respondents reporting an increase minus percentage reporting a decrease.

Chart 2
Business Outlook Survey
Current New Orders and Shipments



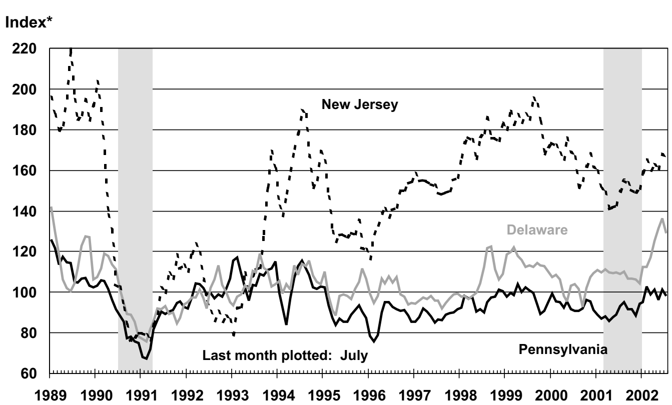
* Index represents percentage of respondents reporting an increase minus percentage reporting a decrease.

Chart 3
Business Outlook Survey
Future General Activity



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

Chart 4
Housing Permits
Single Family Units



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

Auto Sales Support Consumer Spending

A high rate of auto sales in the region, as well as in the rest of the nation, was given renewed impetus with the extension of manufacturers' incentives in September. Rebates and zero- or low-interest-rate financing that apply to both 2002 and many new 2003 model vehicles are keeping auto sales at a robust pace. Consumer spending on other goods does not appear to be as strong. Retailers in the region reported a lackluster back-to-school shopping period. Although there was the usual seasonal increase in sales of school supplies, many merchants said apparel sales did not pick up as expected. Hotter than normal weather and the lack of a strong fashion trend were given as reasons for the disappointing sales results. Despite the third-quarter weakness, stores in the region posted very slight year-over-year gains in total sales for August and September.

The summer vacation period also failed to meet expectations in the tourism industry. In each of the three states in the region (Pennsylvania, New Jersey, and Delaware), tourist activity weakened as the summer progressed. Although the number of tourists and vacationers equaled or exceeded last year's levels in most vacation spots, extended stays and spending per visitor failed to match last year's numbers in many locations. The drop in tourism coming on top of a continuing decline in business travel is likely to result in a decrease from last year in total spending on travel and tourism in the region in 2002.

Real Estate Activity Moderates

The region's commercial real estate markets have continued to ease. The most recent surveys by area real estate firms indicated that vacancy rates have increased 1 to 2 percentage points in most markets since spring. The office vacancy rate in the Philadelphia central business district is estimated at around 14 percent. Downsizing by companies in the city has reduced demand for space, and conversion of retail buildings to offices has increased the supply. Vacancy rates in most suburban markets are higher than the center city rate. The most recent estimates average around 20 percent. New buildings are still adding to supply in the suburbs. Effective rental rates have eased as building owners have expanded capital commitments, such as building improvements and free rent periods, for tenants. Building activity remains fairly high as a number of commercial and public projects are under way, but the pace of new construction contracts has declined since the first half of the year. Commercial real estate executives believe markets are not likely to tighten until some time in 2003, after a number of buildings currently under construction are completed and leased.

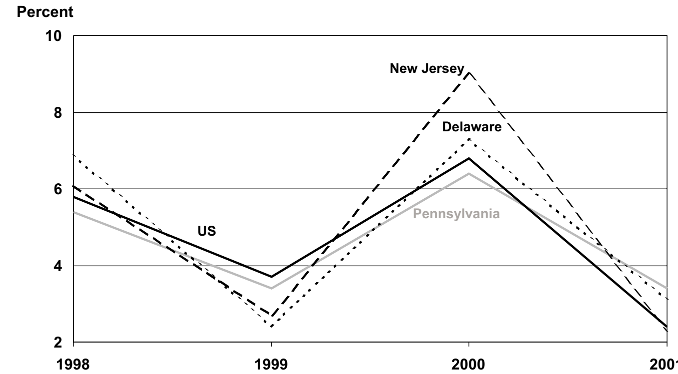
Residential real estate agents generally reported an easing in the rate of sales of both new and existing homes in July and August, although the number of sales in those months was still said to be relatively high by recent standards. Price appreciation remains rapid in many parts of the region. Builders and real estate agents said supply and demand for homes appear to be coming into balance, however, which should temper the rate of price increase. The pace of new home construction remains high, but the general trend in recent months has been steady to slightly down in each of the three states in the region (Chart 4).

Income Growth Slows

Recently released revisions of state personal income data reveal that the recession that began in March 2001 has significantly reduced income growth in nearly all states, including the three states in the region. Nominal per capita income growth for the U.S. as a whole last year was less than half the pace set in 2000. Forty-eight states had slower per capita income growth in 2001 than 2000; only two had faster growth—Louisiana and New Mexico. In the tri-state region, the greatest slowdown was in New Jersey, where the annual rate of change fell from 9 percent in 2000 to 2.3 percent in 2001 (Chart 5). Per capita income growth fell from 6.4 percent to 3.4 percent in Pennsylvania, and from 7.3 percent to 3.1 percent in Delaware. The sharp drop in per capita income growth in New Jersey reflected a greater proportional decline in the growth rate of wage and salary earnings of New Jersey residents compared with residents of other states. Among the major industry groups in New Jersey, earnings in manufacturing declined from 2000 to 2001 along with employment in that industry group. Manufacturing earnings declined nationwide, but the decline in New Jersey was greater than in the nation. An additional drag on earnings growth in New Jersey was a large drop in the growth rate of earnings in the finance-insurance-real estate sector, although employment in that industry group increased from 2000 to 2001.

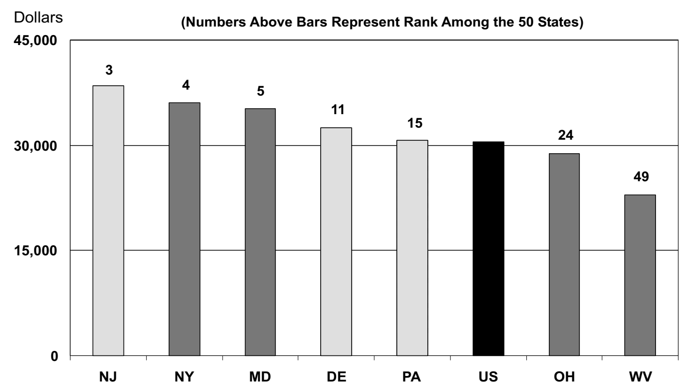
There was little change in rankings of states by per capita income between 2000 and 2001. New Jersey ranks third in the nation and highest among neighboring states; Delaware and Pennsylvania are in the top 15 states and in the middle of the range of neighboring states (Chart 6).

Chart 5
Per Capita Income Growth
Annual Growth Rates
1998-2001



Source: Bureau of Economic Analysis.

Chart 6
Per Capita Income
Pennsylvania, New Jersey, Delaware,
and Neighboring States, 2001



Source: Bureau of Economic Analysis.

Employment Decline Eases

The downward trend in employment in the region, as well as in the nation, appeared to be bottoming out in the third quarter, based on data for July and August. (See Table 1 on page 4.) Nationally, total employment eked out a small increase for the quarter, largely as a result of gains in the services and finance-insurance-real estate industry groups. In the region there were increases in total employment in Pennsylvania and Delaware. For Pennsylvania the increase came from slightly improved employment in construction and services. For Delaware the gains came in government employment and transportation and public utilities. New Jersey had a decrease in total employment; declines in manufacturing, transportation-public utilities, and finance-insurance-real estate more than offset increases in services, wholesale and retail trade, and construction.

From March 2001, when the recession began, until August of this year (the latest month for which data are available) the industry groups suffering the greatest proportional employment declines have been manufacturing and transportation-public utilities. This has been the case nationally and for each of the three states in the region. Since the beginning of the year those declines have moderated in the nation and in each of the states in the region. However, since the start of the year employment declines have worsened in the finance-insurance-real estate sector, both nationally and in the region. The national decline stems from drops in employment at securities firms and insurance companies. Declines in employment in these sectors account for much of the drop in financial industry employment in New Jersey. There have been declines in employment in these sectors in Pennsylvania, also. Additionally, there have been declines in employment at depository institutions in Pennsylvania, as consolidation among banks continues in the state. Delaware also experienced a slight decline in depository institution employment.

A Modest Recovery Ahead

Business firms in the region expect a modest recovery, although many feel that prospects for the immediate future have become more uncertain. Manufacturers forecast increases in shipments and orders during the next six months, but their capital spending plans are not as strong as they were earlier this year. Retailers expect slight gains in sales this fall, but they are also looking for ways to cut costs in order to maintain profitability.

Table 1
Unemployment Rates and Employment Growth*
Seasonally Adjusted

	2001			2002		
	II	III	IV	I	II	III**
3-STATE TOTAL						
Unemployment Rate	4.4	4.5	4.9	5.4	5.5	5.3
Payroll Employment Growth	0.0	-0.2	-0.3	-0.2	-0.2	0.0
PENNSYLVANIA						
Unemployment Rate	4.6	4.8	5.0	5.6	5.5	5.4
Payroll Employment Growth	-0.1	-0.1	-0.7	-0.2	-0.1	0.1
NEW JERSEY						
Unemployment Rate	4.1	4.3	4.8	5.2	5.6	5.4
Payroll Employment Growth	0.1	-0.4	0.1	-0.1	-0.3	-0.1
DELAWARE						
Unemployment Rate	3.4	3.3	3.3	3.7	4.2	3.9
Payroll Employment Growth	0.0	-0.6	-0.1	-0.5	0.0	0.2
UNITED STATES						
Unemployment Rate	4.5	4.8	5.6	5.6	5.9	5.8
Payroll Employment Growth	-0.2	-0.2	-0.6	-0.3	0.0	0.1

* Percent change from previous quarter.
** 2002:III represents two months of data.

Real estate executives anticipate steady residential sales, but they do not foresee improvement in commercial markets until next year.

Economists participating in the Philadelphia Fed's latest *Survey of Professional Forecasters* have scaled back their forecasts for growth in GDP this year and next. Their forecast now is 2.3 percent for 2002 and 3.0 percent for 2003 (down from 2.7 percent and 3.4 percent, respectively, forecasted in May). In the context of a modest recovery in the national economy, our regional forecasting model predicts a slow improvement in employment for each of the three states in the region, but little change in unemployment rates (see Table 2.)

Timothy Schiller
Senior Economic Analyst

Shannon Mail
Research Associate

Table 2
Employment Growth and Unemployment Rate Forecasts

	PA	NJ	DE
Job Growth (2002:II to 2003:II)	1.1%	1.4%	1.3%
Unemployment Rate (2003:II)	5.3%	5.4%	4.1%