



# REGIONAL HIGHLIGHTS

Second Quarter 2003

## Signs of Improvement

There were some welcome, although slight, signs of improvement in the regional economy during the second quarter. Indicators in the beleaguered manufacturing sector turned up. Retail sales also gained. Residential sales and construction continued to be strong; however, commercial real estate remains slack. Employment in the three states of the region increased slightly in April and May. Employment conditions have been somewhat better in the region than in the nation. Although the most recent employment data show improvement, a solid advance has yet to take hold. The outlook is for only slight job growth during the next four quarters and sluggish improvement in overall business conditions until a stronger recovery in jobs gets under way.

### Manufacturing Decline Eases

The decline in regional manufacturing activity that set in during the first quarter showed signs of bottoming out as the second quarter came to a close. Opinion among manufacturers participating in the Philadelphia Fed's *Business Outlook Survey* turned slightly positive, on balance, in June after three months during which negative assessments of general business conditions outnumbered positive views (Chart 1). With respect to their own companies, manufacturers were divided, with about equal numbers reporting increases and decreases in new orders and shipments (Chart 2). Although these results do not signal an end to the manufacturing slump, they do reflect some improvement since April.

The deterioration in business conditions in March and April and the modest improvement since then might be attributable to disruptions associated with the Iraq War. In fact, about one out of four of the manufacturing firms participating in the *Business Outlook Survey* reported declines in orders when the war began, and about one out of six reported that orders increased with the end of major hostilities. On balance, manufacturers anticipate further increases in orders. Expectations of increases in orders among firms in the *Business Outlook Survey* rose in June to their highest level since May of last year (Chart 3).

Manufacturers' views of the course of business during the second half of the year have improved, but their plans for capital spending are only modestly positive. Nearly half of the firms polled in June plan to keep capital spending steady, and around one-fourth plan to increase spending. Not surprisingly, firms that plan to step up outlays for new plant and equipment report that they need to expand capacity to meet growing demand, and firms that do not plan to increase spending report that sales of their products have been slow and their capacity utilization is low.

### Retail Sales Edge Up

Retailers in the region generally had a pickup in sales in May, as a rainy Memorial Day weekend made trips to malls and shopping centers more attractive than trips to the region's beaches or mountains. The upturn in sales continued into June, as did the rainy weather, but the calendar seemed to be more imperative than the weather forecast in prompting

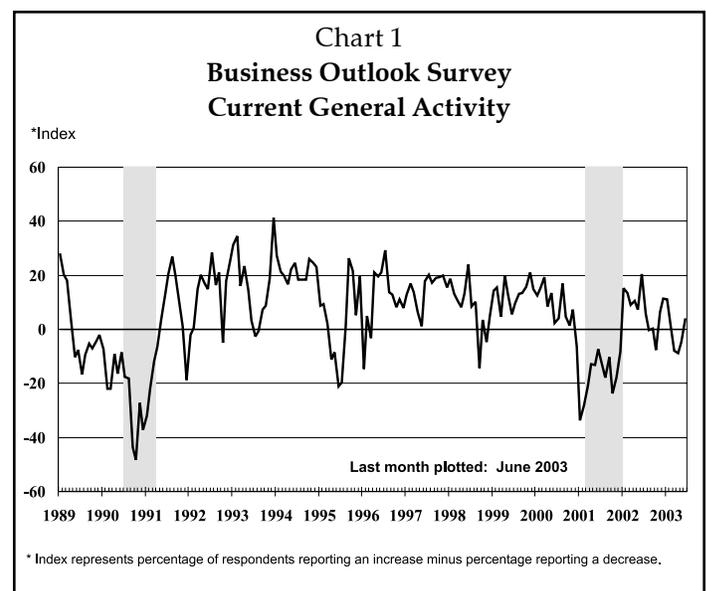
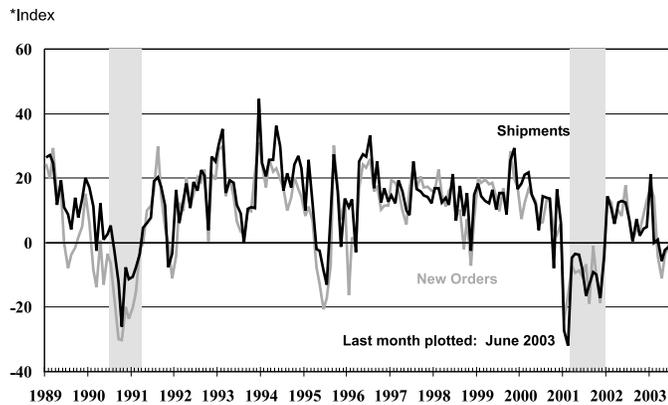
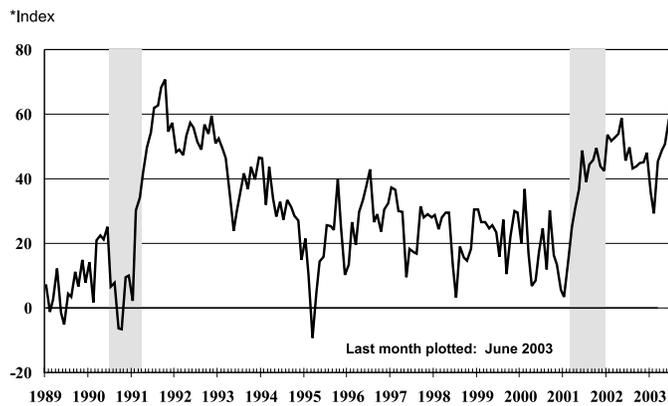


Chart 2  
Business Outlook Survey  
Current New Orders and Shipments



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

Chart 3  
Business Outlook Survey  
Future New Orders



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

sales of summer goods. The improvement in sales in late spring followed lackluster April sales results. Merchants indicated that cold weather during April kept consumers from buying seasonal merchandise, especially warm weather apparel. They added that lingering weakness in consumer confidence has also been a factor in the slow and uneven growth in retail sales in the region, as it has been in the nation.

Auto sales in the region have been fluctuating month to month. There were declines early in the second quarter and a slight improvement later. Nevertheless, sales appear to be running below last year's pace despite expanded financing incentives from some makers. Sales of domestic vehicles have been generally weaker than sales of imported cars.

Warm weather entered the region in late June and should boost sales of seasonal merchandise, but retail executives in the region expect the second half as a whole to be challenging. They believe consumers' concerns about employment security

will limit growth in spending until there is clear evidence that job markets are improving. Auto dealers expect sales for this year as a whole to be below last year's levels even with expanded incentives from manufacturers.

### Residential Real Estate Markets Remain Strong

Sales of both new and existing homes showed continuing strength in the second quarter as the demand for homes increased markedly while the increase in supply did not keep pace. Residential real estate agents in the region noted a pickup in the sales rate in May, as did home builders. In some parts of the region the inventory of existing homes for sale has declined and purchase prices have been rising strongly. Builders also reported rising prices for new homes in some areas, especially where land available for development is scarce.

Housing construction is on the rise in the region, although the trend is not up in all areas. There were increases in housing permits from April to May in New Jersey and Delaware, but a drop in Pennsylvania. On a three-month moving average basis, to smooth month-to-month fluctuations, permits have been rising recently in all three states (Chart 4). Although on the rise, recent monthly levels of permit issuance have been below last year's levels in Pennsylvania and New Jersey. In Delaware, the sharp increase in May brought the latest number up almost to the highest monthly number recorded last year.

Prospects for the national housing market remain bright, according to both the National Association of Realtors and the National Association of Homebuilders. Both organizations expect sales in 2003 to match or slightly exceed the level set in 2002. In the region, views are mixed. Some residential real estate agents expect sales of existing homes to exceed last year's results, and some builders expect sales of new homes this year to top last year's numbers. However, some real estate agents see fewer existing homes being put up for sale this year, and some builders see limitations on construction as a result of decreasing amounts of land being made available for development in many parts of the region.

### Commercial Real Estate Markets Are Still Soft

In contrast to the strong residential real estate market, commercial real estate markets in the region remain weak. Although office vacancy rates have not shown much change in the last few quarters, they remain at their highest levels since the mid-1990s (Chart 5). Vacancy rates have been higher in suburban markets, where recently completed buildings have come on the market, than in central Philadelphia, where there has been no recent office construction. Quoted rents have been fairly steady, but effective rental rates continued to decline during the second quarter as landlords offered greater tenant improvement allowances and rent-free periods to attract and retain tenants. Leasing activity has been soft throughout the region, but there has been an increase in purchases of top-rated office buildings in the Philadelphia central business district by real estate investment firms.

With lackluster demand for office space, construction activity in the region has been flat recently. Although there

have been typical monthly fluctuations in nonresidential construction contracting, it appears that the value of contracts this year will be below last year. Demand for industrial buildings, primarily warehouse and flex space, has been somewhat more resilient than demand for office space. This category of nonresidential construction along with road and bridge maintenance and construction has been providing some support to contracting in the region. But a solid advance in nonresidential construction activity will depend on an increase in demand for office space, which most local commercial real estate agents do not expect until next year at the earliest, and only if employment in the region begins a steady move up.

### Employment Shows Some Improvement

Employment moved up in the region during the second quarter. Job levels increased in all three states of the region—Pennsylvania, New Jersey, and Delaware—in April. The advance continued in May in New Jersey and Delaware, but there was a fallback in Pennsylvania. Averaging the two months of the second quarter for which data are available yields quarterly increases in employment in all three states (see Table 1 on page 4). This is in contrast to the nation as a whole, which had a slight decline in employment. The average unemployment rate in the second quarter (based on April and May) edged down in Pennsylvania, was unchanged in New Jersey, and rose in Delaware. For the second quarter, all three states in the region have lower unemployment rates than the nation.

The growth in employment in the region has been relatively stronger in the service sector than in other sectors, which had smaller proportional gains or outright losses. The increase in service employment in the region also largely accounts for the region's quarterly employment gain in the face of a national employment decline. In contrast to growth in the region's service sector, in the nation many service industries had weaker employment growth or outright declines in the second quarter.

It has been 26 months since the National Bureau of Economic Research dated the beginning of the recession—March 2001—and an ending date has not yet been determined even though GDP has been on the rise for six consecutive quarters. In the 26 months since March 2001 employment has declined in the nation and in Pennsylvania and Delaware. The decline in employment has been greater in Delaware than in the nation; the decline in Pennsylvania has been less. In New Jersey there has been a slight increase in jobs over the 26 months.

Comparing employment in the recession that began in March 2001 to the two prior recessions also reveals differences among the states in the region and between them and the nation (Chart 6). In the 26 months since March 2001 national employment has fallen more than in the comparable period from the start of the two previous recessions. For states in the region, the record is mixed. In Pennsylvania, the decline in employment has been less since March 2001 than in the 26 months after the start of each of the previous two recessions. New Jersey employment has increased slightly, compared

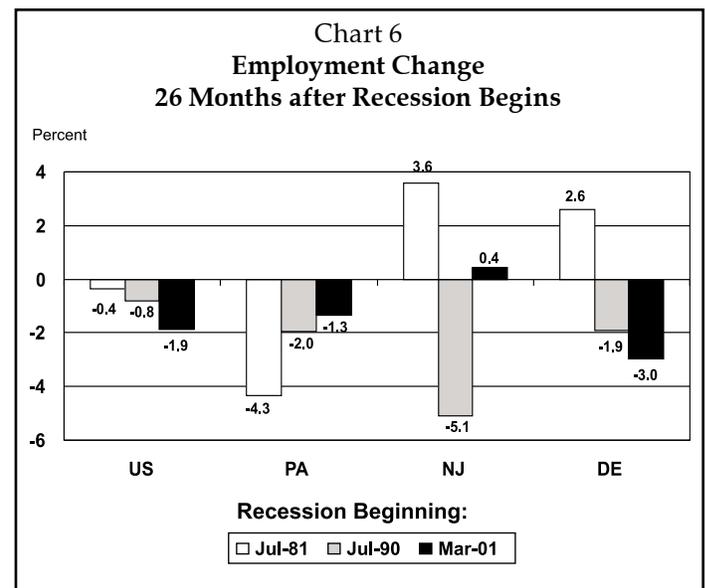
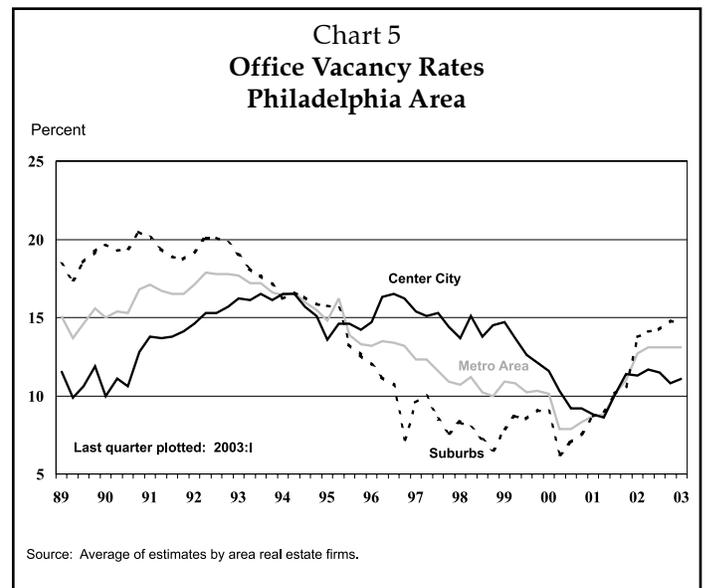
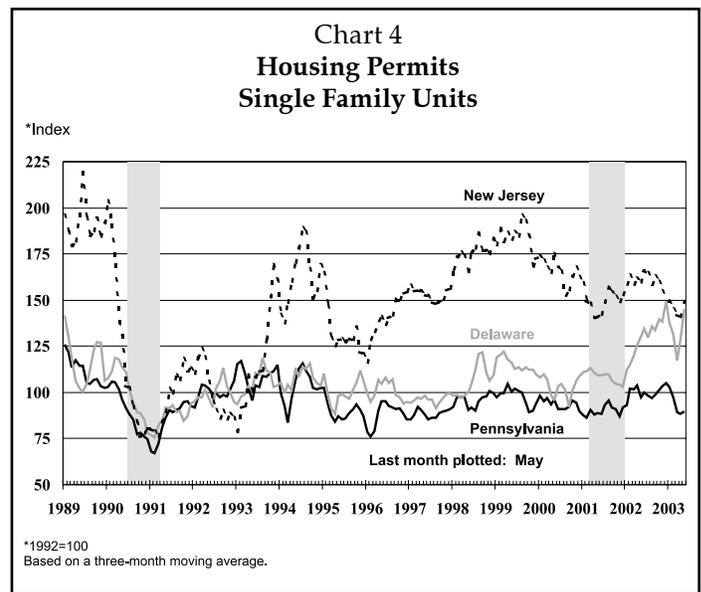


Table 1  
**Unemployment Rates and Employment Growth\***  
**Seasonally Adjusted**

	2002				2003	
	I	II	III	IV	I	II**
<b>3-STATE TOTAL</b>						
Unemployment Rate	5.5	5.6	5.7	5.9	5.8	5.7
Payroll Employment Growth	0.1	-0.1	-0.1	0.0	-0.3	0.3
<b>PENNSYLVANIA</b>						
Unemployment Rate	5.5	5.6	5.7	5.9	6.0	5.8
Payroll Employment Growth	0.1	0.1	0.0	-0.2	-0.4	0.1
<b>NEW JERSEY</b>						
Unemployment Rate	5.5	5.8	6.0	6.0	5.7	5.7
Payroll Employment Growth	0.2	-0.3	-0.1	0.2	-0.1	0.5
<b>DELAWARE</b>						
Unemployment Rate	4.0	4.3	4.3	4.3	3.7	4.3
Payroll Employment Growth	-0.6	-0.3	-0.1	0.7	-1.1	0.2
<b>UNITED STATES</b>						
Unemployment Rate	5.6	5.8	5.8	5.9	5.8	6.1
Payroll Employment Growth	-0.3	-0.1	-0.1	0.1	-0.1	-0.1

\* Percent change from previous quarter.  
 \*\* State and U.S. numbers reflect two months of data.

with a stronger increase 26 months after the start of the 1981 recession and a decrease after the start of the 1990 recession. Delaware employment has fallen more since March 2001 than it did 26 months after the start of the 1990 recession and the 1981 recession when there was an increase.

**Sluggish Improvement Ahead**

Business firms in the region have modestly positive views of near-term conditions. As noted above, manufacturers expect improvement in the second half of the year. Home builders are also optimistic. Retailers are looking for gains, but they expect a difficult sales environment. Conditions in commercial real estate are dependent on stronger employment growth, which is also a factor in retailers' forecasts. The Philadelphia Fed's forecasting model for employment predicts only slight increases in jobs in the three states during the next four quarters (see Table 2).

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Table 2  
**Regional Forecast**

	Forecast 2003:I - 2004:I			Actual 2002:I - 2003:I		
	PA	NJ	DE	PA	NJ	DE
Employment	0.7	0.8	0.4	-0.4	-0.3	-0.7
Unemployment Rate*	6.3	6.2	4.1	6.0	5.7	3.7

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