



# REGIONAL HIGHLIGHTS

Fourth Quarter 2004

## Business Conditions Improve Moderately; Employment Gains Continue

Business activity in the tri-state region (Pennsylvania, New Jersey, and Delaware) increased in the fourth quarter at about the same pace as in the third quarter. Manufacturing continued to expand. Activity increased in the service sector, and retail sales rose moderately. In contrast to gains in these industries, residential building activity eased from the third quarter to the fourth quarter. Demand for commercial real estate has shown little change, although major new buildings are to be built in central Philadelphia. Employment in the three states of the region increased in the fourth quarter, but the gain was slightly less than in the third quarter. The Philadelphia Fed is forecasting a pickup in employment growth through the first three quarters of 2005 in the three states and further declines in unemployment rates.

### Manufacturing Activity Remains on the Rise

Activity in the region's manufacturing sector continued to expand in the fourth quarter. This marked the sixth consecutive quarter of expansion among the manufacturing firms participating in the Philadelphia Fed's Business Outlook Survey (Chart 1). During the fourth quarter, growth in demand was especially notable among manufacturers of electrical equipment and makers of measurement and control instruments. Many of these products are capital equipment, and firms throughout the nation stepped up their capital spending in 2004. In the region, increased capital spending was also evident among the firms that participate in the Business Outlook Survey (Chart 2).

Area manufacturers continued to report rising prices for industrial commodities in the fourth quarter, and they raised prices for their own products as well. Many manufacturers expect further price increases for commodities in 2005, especially for raw materials (including energy), and for business services and transportation. Practically all the manufacturing firms surveyed expect higher costs for employee health-care benefits in 2005.

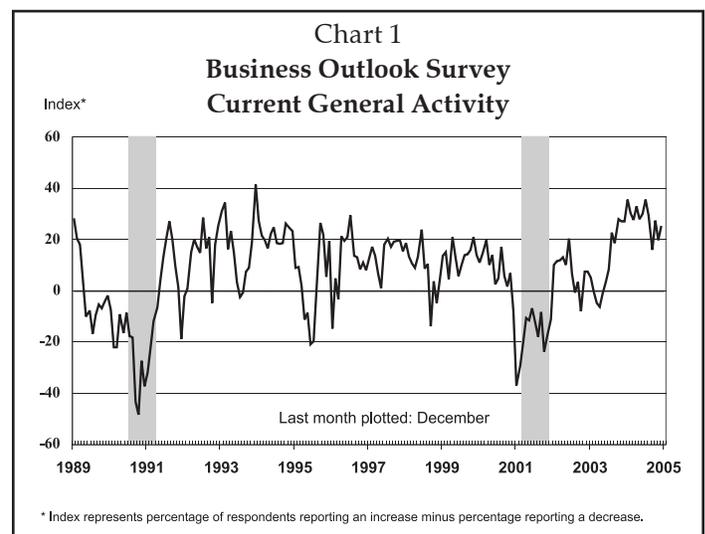
Area manufacturers expect continued increases in activity in the first half of 2005 (Chart 3). Half of the firms that were polled in the December survey forecast that business will increase during the next six months, and only one in eight expects business to decrease.

### Retail Sales Gain Moderately

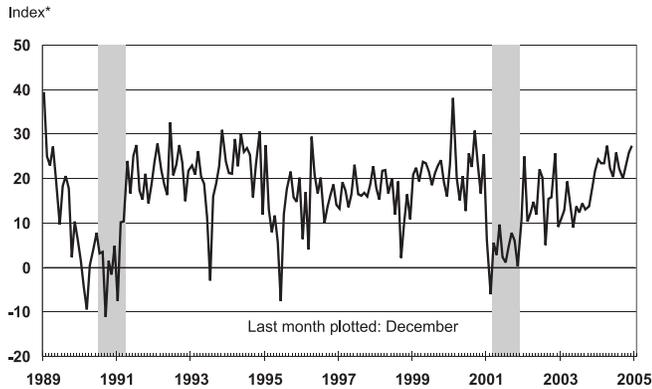
Retailers in the region generally posted a moderate increase in sales for the fourth quarter of 2004 compared with the fourth quarter of 2003. Jewelry sales were fairly strong throughout the quarter, as were sales of luxury goods generally. For most of 2004 sales of luxury goods increased more rapidly than other types of merchandise both nationally and in the region. Clothing sales were solid in the region as most lines of fall apparel proved popular with consumers, although a few retailers indicated that their sales gains were not as great as they had expected.

Overall, retailers in the region reported results similar to those of retailers throughout the country. Nationally, the U.S. Census Bureau's survey of retail sales indicated that the largest year-over-year increases in the fourth quarter were among general merchandise stores (including discount retailers but excluding department stores), while clothing, furniture, and appliance stores had moderate increases. Department store sales were barely above the level of a year ago, although strong gains in luxury goods boosted sales at those department stores that specialize in them.

Most retailers in the region met their expectations for the Christmas shopping period. Overall, year-over-year retail sales

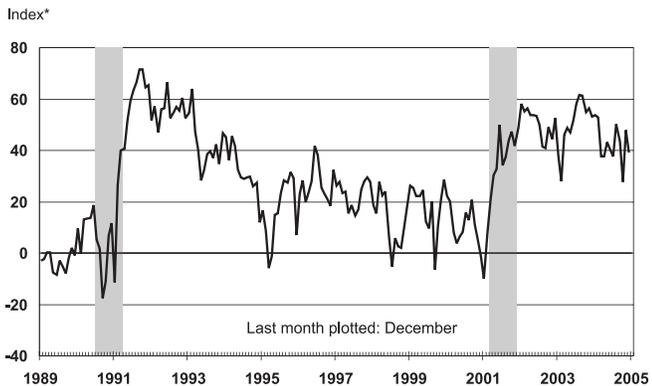


**Chart 2  
Business Outlook Survey  
Future Capital Expenditures**



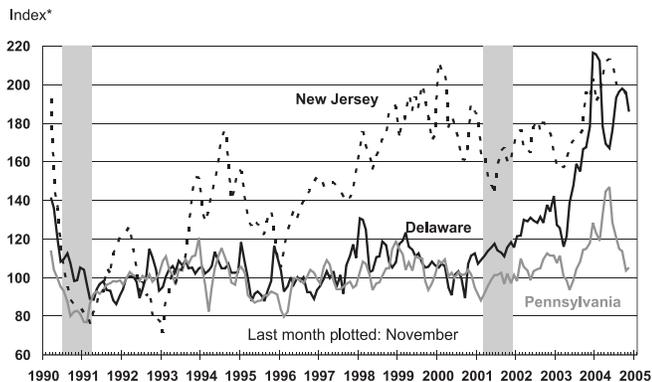
\* Index represents percentage of respondents reporting an increase minus percentage reporting a decrease.

**Chart 3  
Business Outlook Survey  
Future General Activity**



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

**Chart 4  
Total Housing Permits**



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

growth was estimated at a modest 3 percent or slightly higher. The relatively stronger performance of luxury goods that characterized most of the year was evident in the Christmas shopping period as well. Some stores in this category posted gains in excess of 10 percent. The shopping season started slowly, and stores were prompt with price markdowns. However, most stores had kept inventories under control going into the season, and sales improved during the last two weeks of December. Consequently, the extent of discounting was about the same as in 2003, and stores sold out most of their Christmas inventories. Looking ahead, the region's retailers generally expect sales in the winter months to increase modestly, growing at or near the rate achieved in the fourth quarter of last year.

Auto sales in the region generally followed the same trend as national sales in the fourth quarter of 2004, showing a small increase compared with the fourth quarter of 2003. However, dealers in the region did not appear to achieve quite the strong increase in sales observed nationally in December. Although some import dealers posted healthy gains, domestic dealers had weaker increases or declines for December compared with the same month in 2003. At year-end, auto inventories were mostly high at area dealers, and they were looking to a continuation of manufacturers' rebates to promote sales.

### Residential Building Eases; Home Prices Rise

Residential building in the region eased during the fourth quarter. Issuance of housing permits in each of the three states has been on a downward trend since the first half of 2004 (Chart 4). Permit issuance in the fourth quarter was below the rate of the third quarter and below the rate of the fourth quarter of 2003. In contrast to the decrease in the region over the past four quarters, the nation has had a slight increase.

Residential real estate agents in most parts of the region saw steady sales of existing homes during the fourth quarter. In some areas, the length of time homes are on the market has increased, but for the region as a whole, demand for homes remains strong. Evidence of strong demand can be seen in continuing increases in home prices. Real estate agents in the three states reported no letup in price appreciation for existing homes during the fourth quarter, and builders in many areas raised prices for new homes. The latest data from the Office of Federal Housing Enterprise Oversight (OFHEO) indicated strong price increases for existing houses in the nation during the third quarter, which boosted the year-over-year gain to its highest reading in 25 years. In the region, price appreciation rose in each of the states in the third quarter, and the year-over-year increase in each state was above the national average (Chart 5). The increase was 19 percent in New Jersey, 17 percent in Delaware, and 13 percent in Pennsylvania. These increases rank New Jersey 8th, Delaware 11th, and Pennsylvania 17th among the 50 states and the District of Columbia in house price appreciation. Among the metropolitan areas in the three-state region tracked by the OFHEO, those in New Jersey, Delaware, and eastern Pennsylvania had year-over-year gains equal to or above the national average, but those in central and western Pennsylvania lagged behind the nation (Chart 6).

### Commercial Real Estate Softness Persists

Conditions in commercial real estate markets have been roughly steady in the past few months. Office vacancy rates

in the third quarter (latest available estimates) showed little change from the beginning of the year. However, effective rents have declined as landlords compete for new tenants and lease renewals. Commercial real estate firms expect office vacancy rates to fall in the year ahead in most parts of the region. They anticipate a turn toward better balance between supply and demand in suburban markets, but not in Philadelphia's central business district, where new construction spurred by state and local financing incentives will add significantly to the amount of office space available. Industrial building vacancy rates have changed little in recent months, but rents have declined in most parts of the region. However, there are some areas of strong demand along the interstate highways in New Jersey and Pennsylvania, and construction of industrial and multi-use buildings has picked up somewhat in these locations.

**Employment Rises, but Growth Rate Slows**

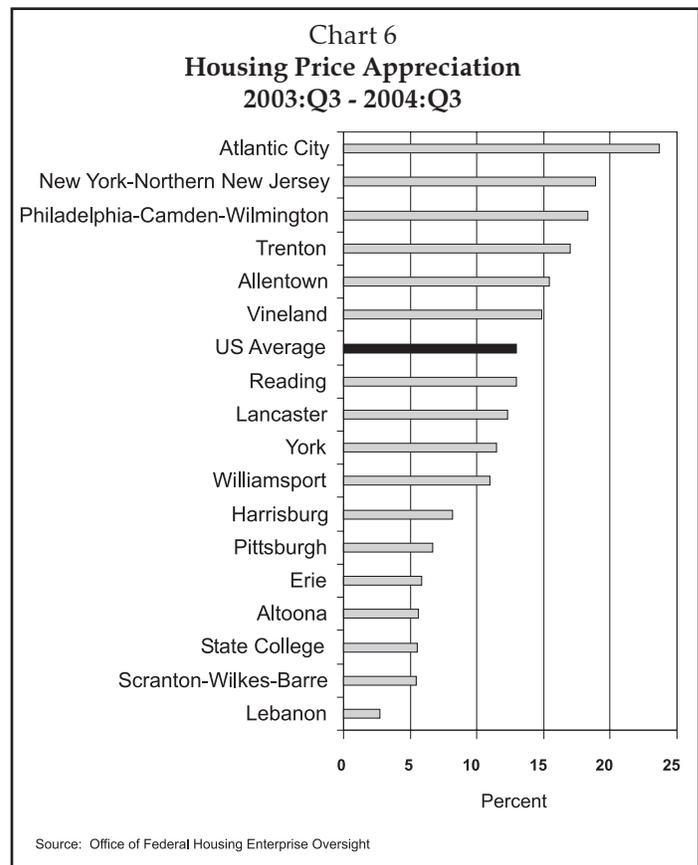
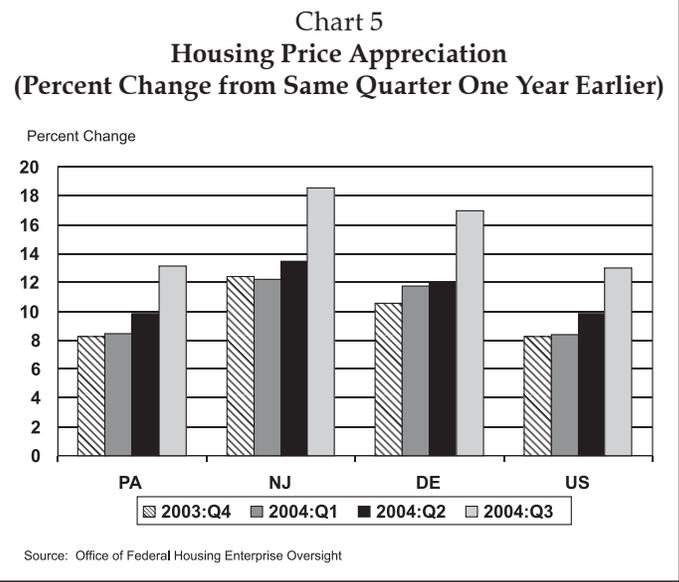
Employment increased in the fourth quarter in each of the states, as it did in the nation, but the pace of growth in the region eased somewhat from the third quarter (see Table 1 on page 4). Compared with the third quarter, there were gains in most of the major industry supersectors defined by the U.S. Bureau of Labor Statistics. The largest percentage increases were in construction in New Jersey and the nation, and in professional and business services in Pennsylvania. There were also notable gains in "other services" (repair and personal services) in New Jersey and in trade-transportation-utilities in each of the three states. There were decreases in manufacturing employment in the nation and each of the three states. Also, information services employment slipped in Pennsylvania, and professional and business services declined in New Jersey.

The unemployment rate in each of the three states and in the nation showed little change from the third quarter to the fourth quarter. Unemployment in New Jersey and Delaware is below the national rate. The unemployment rate in Pennsylvania edged up during the past three quarters and matched the national rate as 2004 came to a close.

**Moderate Improvement Is Forecast**

The consensus in the region's business community is that business activity will continue to expand at its current rate. Manufacturers forecast increases in shipments and orders during the next six months. Firms in the service sectors of the regional economy look for steady or slightly faster growth in 2005 compared with 2004. Retailers expect increased sales during the winter, and they anticipate year-over-year growth for the first quarter of 2005 to be around the same as growth in the fourth quarter of last year. However, auto dealers anticipate some slowing in sales during the year. Both home builders and residential real estate agents expect the pace of home sales to remain at or near the current pace unless mortgage interest rates move up significantly. Commercial real estate firms anticipate a slow turn toward lower vacancy rates for office buildings in suburban markets during the year, but they expect new construction in central Philadelphia to prevent the city's vacancy rate from declining soon.

The employment outlook is positive, as comments from employers indicate that more plan to add to employment than to reduce it in the first quarter. The Philadelphia Fed is forecasting increases in employment in each of the three states of 1.4 to 1.8



percent from the third quarter of this year to the third quarter of next year. This represents a slight pickup in job growth compared with the previous four quarters (see Table 2).

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

	Quarterly*						Annual	
	2003		2004				2002:IV - 2003:IV	2003:IV - 2004:IV
	III	IV	I	II	III	IV**		
<b>3-STATE TOTAL</b>								
Unemployment Rate	5.6	5.4	5.2	5.1	5.2	5.0	5.7	5.2
Payroll Employment Growth	0.4	0.1	0.0	3.0	1.5	1.2	-0.2	1.4
<b>PENNSYLVANIA</b>								
Unemployment Rate	5.5	5.3	5.2	5.3	5.4	5.5	5.6	5.3
Payroll Employment Growth	-0.8	-0.8	-0.4	2.9	1.2	1.0	-0.7	1.2
<b>NEW JERSEY</b>								
Unemployment Rate	5.9	5.6	5.4	5.0	4.9	4.6	5.9	5.1
Payroll Employment Growth	2.0	1.2	0.6	3.1	1.7	1.2	0.6	1.6
<b>DELAWARE</b>								
Unemployment Rate	4.5	4.4	3.5	3.8	3.8	4.0	4.3	3.9
Payroll Employment Growth	1.1	1.7	-0.6	2.9	2.3	3.4	0.5	2.0
<b>UNITED STATES</b>								
Unemployment Rate	6.1	5.9	5.7	5.6	5.4	5.4	6.0	5.6
Payroll Employment Growth	-0.2	0.6	1.1	2.3	1.2	1.8	-0.2	1.6

\* Payroll employment growth is annualized change from previous quarter.

\*\* Quarter IV 2004 is computed with two months of data for the states.

Table 2  
**Regional Forecast**

	Forecast 2004:III - 2005:III			Actual 2003:III - 2004:III		
	PA	NJ	DE	PA	NJ	DE
Employment	1.4	1.8	1.8	0.8	1.6	1.6
Unemployment Rate*	5.0	4.5	3.4	5.4	4.9	3.8

\* Unemployment rate forecasts represent the expected unemployment rate in 2005:III, while the actual unemployment rate represents 2004:III.