



REGIONAL HIGHLIGHTS

Second Quarter 2006

Business Activity Increases; Housing Demand Eases

Economic activity in the tri-state region (Pennsylvania, New Jersey, and Delaware) continued to expand in the second quarter, and there was a rise in employment. Manufacturing activity increased. Retail sales of general merchandise rose, although auto sales weakened. The demand for housing has softened: sales of existing homes have been trending down; sales of new homes have been bolstered by builders' incentives, but permits to build new homes have declined. Employment in the three states of the region increased, although the unemployment rate has shown little change. The Philadelphia Fed is forecasting continued job growth in each of the three states and virtually steady unemployment rates.

Manufacturing on an Upward Trend

Manufacturing activity in the region continued on an upward trend during the spring. Manufacturers participating in the Philadelphia Fed's monthly *Business Outlook Survey* reported improving conditions during the second quarter, maintaining the pace of improvement observed in the previous two quarters (Chart 1). Among the District's major manufacturing sectors, business has been relatively strong for producers of industrial and construction materials, lumber, metals, and electrical equipment, but soft for producers of transportation equipment.

Looking ahead, more manufacturers in the region expect business to improve than expect it to decline during the next six months, although the predominance of positive opinions has moderated since the beginning of the year (Chart 2). Besides an anticipated easing in the growth of demand for their products, area manufacturers face some supply constraints. They have experienced shortages and delivery delays for inputs, notably metals and metal products, wood products, and electronic components. They also reported input price increases during the second quarter, especially for lumber, metals, petroleum-based products, and chemicals.

Moderate Gains in Retail Sales

Retail sales in the region picked up during the spring quarter. Warm weather in April, school vacations, and the Easter holiday stimulated spending. Sales increased for most categories of mer-

chandise; the strongest gains were in sporting goods, home and garden supplies, and spring apparel. Sales growth continued into May and June, with summer apparel and other seasonal merchandise selling well. Sales of consumer electronic products were also fairly brisk. Retailers expect sales to grow at about the current rate into the summer months. However, they believe gains in consumer spending will eventually ease if higher gasoline prices and interest rates persist.

Auto sales in the region have slowed, especially for domestic models. Sales of foreign models continued to show some strength, and luxury car sales have been propped up by an increase in leasing. Although more fuel-efficient vehicles are gaining popularity among car buyers, auto dealers in the region expect overall sales to be sluggish for the rest of the year.

Housing Demand Eases

The pace of residential building in the region remained on a downward trend in the spring. Despite an uptick in permits in May, the three-month moving average of total permits fell. Slight

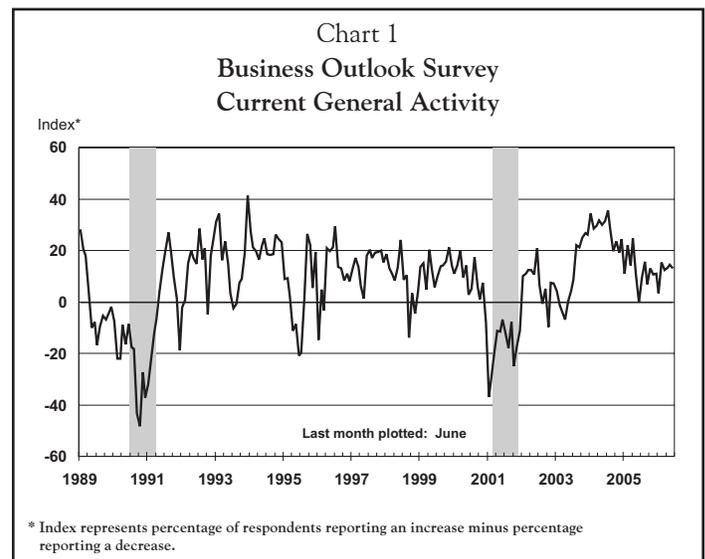
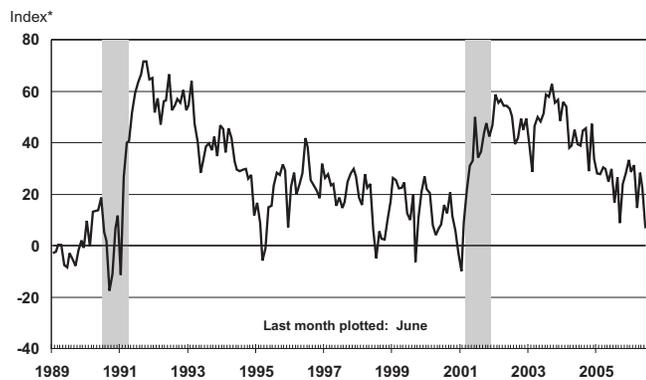
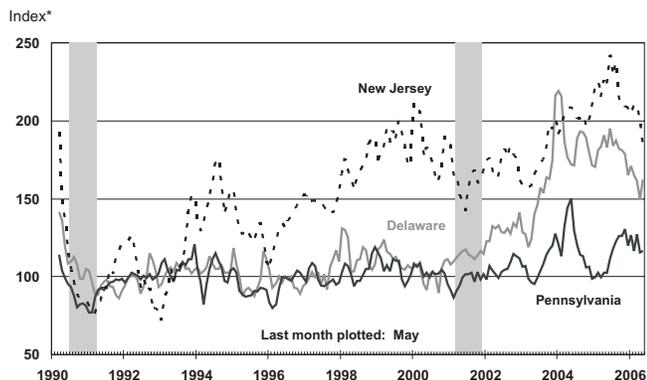


Chart 2
Business Outlook Survey
Future General Activity



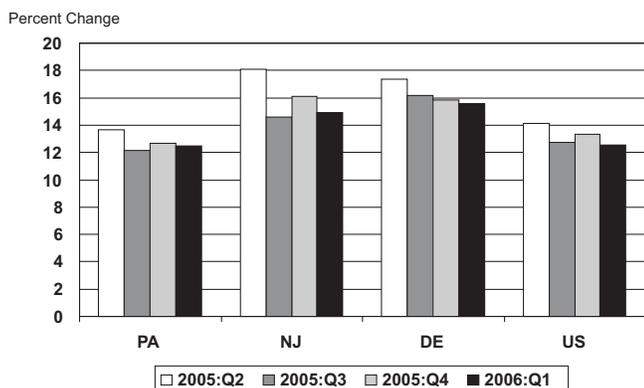
* Index represents percentage of respondents reporting an increase minus percentage reporting a decrease.

Chart 3
Total Housing Permits



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

Chart 4
Housing Price Appreciation
(Percent Change from Same Quarter One Year Earlier)



Source: Office of Federal Housing Enterprise Oversight

gains in Pennsylvania and Delaware were offset by a decline in New Jersey (Chart 3). The gains in each of the states in May paralleled a national increase. Builders in the region and throughout the country have stepped up incentives to bolster sales and appear to have succeeded in attracting buyers. Nonetheless, the longer-term trend is down. Year-to-date permit issuance is off from last year in New Jersey and Delaware; Pennsylvania had an increase. Nationally, permits through May of this year were down from the same period a year ago.

The decline in sales of existing homes that began in the winter continued into the second quarter. This slowdown appears to be gradual in most parts of the region, although in some resort areas sales have declined sharply. The amount of time existing homes are on the market before being sold has been rising, a trend that indicates that home sales will slow further in the second half of the year.

The Office of Federal Housing Enterprise Oversight (OFHEO) reported strong price appreciation for existing houses in the three states and throughout the country during the first quarter of this year (latest available data) but noted that the rate of increase moderated from the pace set last year at the national level. For some areas where price appreciation has been rapid, the slowing was more pronounced. In the three-state region, price appreciation moderated somewhat in New Jersey, where it has been strong, but was nearly steady in Pennsylvania and Delaware. Despite the easing in price appreciation in New Jersey, house prices increased more rapidly there than in the nation. Price appreciation was also faster in Delaware than in the nation during the first quarter. Price appreciation in Pennsylvania remained near the national rate. In the first quarter, the year-over-year increase was 13 percent in Pennsylvania, 15 percent in New Jersey, and 16 percent in Delaware (Chart 4). The national increase was 13 percent. Delaware ranked 13th in house-price appreciation among the 50 states and the District of Columbia, New Jersey ranked 14th, and Pennsylvania ranked 20th.

Commercial Real Estate Markets Remain Firm

Commercial real estate markets remained firm in the second quarter. Vacancy rates in the region's office markets have continued to decline in the past few months. Rents have shown little change overall, however, increasing in some markets and edging down in others. A further gradual tightening of the region's office markets this year is likely if the local economy continues to expand at its current rate. However, the supply of office space in the region will increase this year and next as buildings under construction are completed and corporate consolidation results in some currently leased space coming on the market in the months ahead. The increase in supply from these sources could limit the decline in vacancy rates and also restrain increases in rents.

Demand for industrial space in the region continued to grow, and there has been an increase in the construction of industrial buildings on both a speculative and build-to-suit basis. Unlike the office market, increased demand for industrial space cannot be accommodated readily by existing buildings because prospective tenants usually have very specific needs. Consequently, any increased demand in the region for manufacturing, warehouse, or laboratory space results in an upturn in construction of these types of buildings.

Employment Grows

Employment has been growing in the region as a whole (see Table 1, page 4). In the three months ending in May (latest data), employment increased in each of the states, although not all industries shared in the gains. In Pennsylvania, there were gains in information services, educational and health services, leisure and hospitality, and other services (mainly personal services). There were declines in construction, manufacturing, trade-transportation-utilities, financial activities, and government. In New Jersey, there were gains in all supersectors except manufacturing and information services. In Delaware, there were increases in construction, information services, professional and business services, and leisure and hospitality. There were declines in manufacturing, trade-transportation-utilities, financial activities, and government.

In the past 12 months, total employment growth in the region has been slower than in the nation. Over that period, the region had slower growth than the nation in the supersectors that gained most at the national level—construction, financial activities, and professional and business services—and greater losses than the nation in the two supersectors that declined—manufacturing and information services. Employment growth in educational and health services, leisure and hospitality, and other services was somewhat more rapid in the region than in the nation.

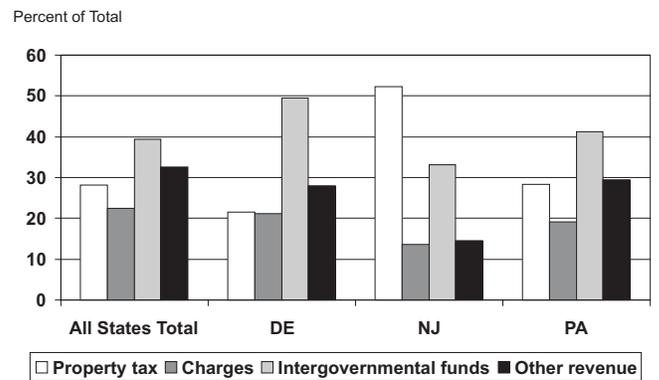
The unemployment rate in the three states as a whole has edged up in recent months. From March to May (latest data), the unemployment rate rose in each of the three states. The May unemployment rates in Pennsylvania and New Jersey were above the national rate. The rate in Delaware remained well below the national rate.

State Taxes in the Spotlight

State and local taxes are receiving attention in Pennsylvania and New Jersey as both states look to shore up revenue while providing some relief from property tax levies. Pennsylvania enacted legislation to expand rebates of local property taxes by increasing the income limit for eligibility and increasing the rebate amounts for senior citizens, effective in 2007. The state is looking to gain tax revenue from slot machine gambling in order to make up for the reduction in property taxes. Legislation also requires school districts in the state to poll voters in 2007 on whether they wish to continue funding schools entirely with property taxes or change to a local personal income tax.

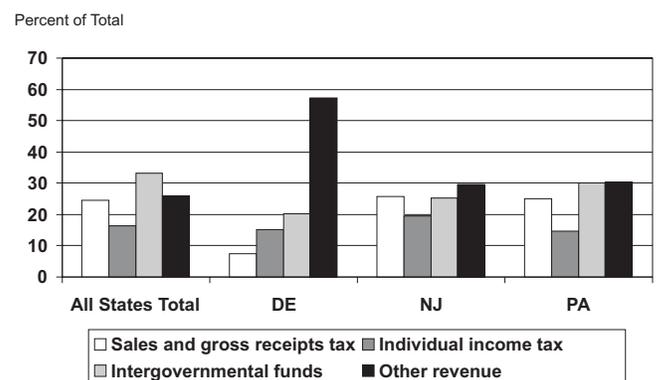
In New Jersey, the recently enacted state budget increases the state sales tax from 6 percent to 7 percent. As part of the legislative arrangement for the budget, a half percentage point of the sales tax will be dedicated to reducing local property taxes. New Jersey voters will be asked in a referendum if they want to make this use of sales tax revenue permanent and if they want to increase the amount from a half to a full percentage point. The importance of property taxes in New Jersey is highlighted by the fact that the share of local government revenue from this source is nearly twice as large in New Jersey as in other states (Chart 5). In Pennsylvania, property taxes as a share of local government revenue are in line with the average of all 50 states. (In Delaware, the property tax share is somewhat less than the average.) Sales and gross receipts taxes account for about as much, proportionally, of state government revenues in New Jersey and Pennsylvania as in other states

Chart 5
Sources of Local Government Revenue



Source: U.S. Bureau of the Census

Chart 6
Sources of State Government Revenue



Source: U.S. Bureau of the Census

(Chart 6). (Delaware does not have a statewide general sales tax, although it does tax motor fuels and some other goods.) The increase in the sales tax rate in New Jersey will increase the share of state revenue from this source.

Moderate Growth Is Forecast for the Region

Third District businesses expect economic activity in the region to continue to expand at a moderate rate during the rest of the year. Manufacturers expect continued gains in orders and shipments, although generally they believe the rate of expansion will be somewhat slower in the second half of the year than it was in the first. Retailers anticipate steady increases in sales, although they are concerned that if interest rates and gasoline prices remain at current levels or increase, this will eventually dampen consumer spending. Auto dealers expect sales to remain sluggish through the rest of the year. Home builders and real estate agents expect home sales and construction to ease. Construction of commercial and

Table 1
Unemployment Rates and Employment Growth
Seasonally Adjusted

	Monthly*									Annual	
	Sep 2005	Oct 2005	Nov 2005	Dec 2005	Jan 2006	Feb 2006	Mar 2006	Apr 2006	May 2006	2006 YTD**	Last 12 Months
3-State Total											
Unemployment Rate	4.6	4.6	4.6	4.6	4.4	4.6	4.5	4.9	4.8	4.6	4.6
Payroll Employment Growth	1.3	0.6	1.2	1.1	1.2	0.9	0.4	0.7	0.7	0.7	0.9
Pennsylvania											
Unemployment Rate	4.8	4.8	4.7	4.7	4.3	4.5	4.5	4.7	4.8	4.6	4.7
Payroll Employment Growth	1.2	0.5	1.1	1.4	1.6	1.3	0.2	0.2	0.1	0.4	0.8
New Jersey											
Unemployment Rate	4.4	4.4	4.5	4.6	4.5	4.7	4.5	5.1	5.0	4.8	4.6
Payroll Employment Growth	1.2	0.6	1.0	0.5	0.5	0.4	0.4	1.2	1.5	1.0	1.0
Delaware											
Unemployment Rate	4.3	4.4	4.5	4.6	3.9	4.0	3.6	3.7	3.8	3.8	4.1
Payroll Employment Growth	3.7	1.9	4.0	1.9	2.6	0.0	2.1	2.7	0.6	0.9	1.1
United States											
Unemployment Rate	5.1	4.9	5.0	4.9	4.7	4.8	4.7	4.7	4.6	4.7	4.9
Payroll Employment Growth	1.4	0.8	1.3	1.6	2.0	1.5	1.6	1.5	1.1	1.3	1.4

*Payroll Employment Growth: monthly numbers represent three-month growth at an annualized rate.

**Growth rates for 2006 Year to Date (YTD) are annualized.

Table 2
Regional Forecast

	Forecasted 2006:I - 2007:I			Actual 2005:I - 2006:I		
	PA	NJ	DE	PA	NJ	DE
Employment	1.0	1.2	1.5	1.2	1.0	1.8
Unemployment Rate*	4.5	4.5	3.9	4.4	4.6	3.8

* Unemployment rate forecasts represent the expected unemployment rate in 2007:I, while the actual unemployment rate represents 2006:I

industrial buildings is also expected to ease, although demand for office and industrial space is expected to remain firm.

The employment outlook is positive. Employers throughout the region indicate that they plan to add to payrolls in the third quarter. The Philadelphia Fed is forecasting increases in employment in each of the three states from the first quarter of 2006 to the first quarter of 2007. Growth is projected to be 1.0 percent in Pennsylvania, 1.2 percent in New Jersey, and 1.5 percent in Delaware. This represents a roughly steady pace of job growth compared with the previous four quarters for Pennsylvania and New Jersey but slightly slower growth for Delaware (see Table 2).

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