Already Weak Regional Economy Hurt by Terrorist Attacks

• Region’s Economy Weak Prior to September 11
• Effects of Terrorist Attacks Most Pronounced in Retail and Travel-Related Industries
• Continued Weakness in Region Expected Through Mid-2002

Economic indicators before September 11 pointed to little, if any, growth in the tri-state area since spring. Following modest growth in the first quarter, employment in the tri-state region declined in the second quarter, and preliminary data suggest that employment will have declined in the third quarter. The region’s manufacturing sector was declining prior to September 11, and manufacturing employment has been either flat or declining for the past 14 months. The pace of residential construction rebounded from a weak first quarter, but nonresidential construction activity has declined in recent months. Retail sales were mostly flat prior to September 11, and retail and travel-related industries in the region suffered setbacks following the terrorist attacks. Many area retailers indicated that they do not expect a full rebound in sales in the near future. Area bankers reported modest increases in lending before September 11, and they expected overall loan growth to remain slow for the balance of this year. Looking ahead, the pace of growth of the regional economy will continue to be weak for the balance of this year and during the first half of next year.

Employment Declined This Year and the Unemployment Rate Moved Up

Data released prior to September 11 already indicated that payroll employment in the tri-state region would decline in the third quarter. Payroll employment in the region decreased 0.2 percent during the first two months of the third quarter, after decreasing 0.2 percent in the second quarter (Figure 1). Declines in employment in the third quarter were broad based, with the relatively largest declines recorded in manufacturing and in transportation, communication, and public utilities. Employment decreased 0.2 percent in all three states during the first two months of the third quarter, the same rate as in the second quarter. The region’s unemployment rate in the past two months of the third quarter, after decreasing 0.2 percent in the first two months of the third quarter, the same rate as in the second quarter.

Manufacturing Output Continues to Decline

Although the Third District’s manufacturing sector continues to decline, there were signs prior to September 11 that the worst may have been behind us. The main index of current activity from the Business Outlook Survey (BOS) remained negative in September, but improved from -23.5 in August to -7.3. Other indicators of current activity, such as the indexes for new orders, shipments, and order backlogs, continued to show weakness in September. However, these indexes have significantly improved from low levels recorded earlier this year. The majority of area manufacturers contacted during the week of September 17 indicated that they did not experience disruptions to their operations on September 11; less than 10 percent of firms contacted indicated a cancellation of employment shifts. Those manufacturers that did experience disruptions on September 11 indicated that any lost production and deliveries were made up during the remainder of the week and early the following week. Few area manufacturers indicated any major disruptions to their supplier and transportation and communication networks, and those experiencing delays described them as temporary and minimal.

Despite the weakness in current conditions, area manufacturers were more optimistic about conditions in the near future prior to the September 11 attacks. The future index of general activity from the September BOS increased from 33.1 in August to 51.3. September marked the fifth consecutive month this index was above 30.0, and the last negative reading was recorded in January of this year. Still, a survey conducted in early September indicated that 55 percent of area manufacturers that experienced a decline in activity did not anticipate a recovery in activity before the second quarter of next year. More recently, manufacturers indicated that it’s too early to evaluate the possible losses in business because of changes in customer expectations following the attacks, although some firms expect slower sales over the next several months. Several manufacturers expressed concern that the
recent improvement experienced in demand for their products may now be lost.

Construction Has Slowed

After decreasing 8.5 percent in the first quarter, the value of residential construction contracts rebounded to the average level achieved during the fourth quarter of last year. Despite this rebound, residential construction contracts in the region are down on a year-over-year basis. Local builders described sales of new homes as steady in July and August, at around the same rate during the same months last year.

The value of nonresidential construction contracts decreased 4.0 percent in the tri-state region for the first eight months of 2001 compared with the same period in 2000, while falling 4.2 percent nationally. All of the weakness in nonresidential construction has been in Pennsylvania, where contracts decreased 11.1 percent. Contracts increased 5.6 percent in New Jersey and 43 percent in Delaware during the first eight months of 2001 compared with the same period last year. The nonresidential construction industry in Delaware is so small that individual projects can have large effects on the number.

According to real estate agents contacted prior to September 11, the demand for office and commercial space softened in the region this year. The office vacancy rate has risen one to two percentage points in the Philadelphia region since spring. In the Philadelphia CBD, the vacancy rate has moved above 9 percent. The vacancy rate was under 8 percent during the first quarter of this year. In suburban markets, the vacancy rate has risen to an average of 12 percent, up from 11 percent during the first quarter. Lack of office construction has kept the vacancy rate relatively low in the CBD. In suburban markets, however, the amount of new space added recently has exceeded demand, and more space is expected to become available during the rest of this year and into next.

Consumer Sector Is the Key to Growth

Local retailers contacted prior to the
attacks indicated that sales during the back-to-school shopping period were up from relatively flat sales in July and early August, although the increase was less than expected. Sales of women’s apparel rose, and a tax-free shopping period for personal computers in Pennsylvania boosted sales of computers and peripheral equipment. Reflecting the lackluster performance in retail, sales tax collections in Pennsylvania through August (which reflect sales through July) have shown some weakness in recent months. Local dealers indicated that auto sales slowed prior to September 11 and inventories had increased. Manufacturers’ incentives were extensive, and dealers noted that rebates and low-cost financing were necessary to maintain a relatively high sales rate. Pennsylvania’s sales tax collections for motor vehicles confirm reports of slow auto sales in the region prior to September 11.

Nearly all major retail stores and shopping malls in the region closed by mid-afternoon on September 11. And retailers report that sales were extremely slow the week following September 11. Retailers have seen a resumption of consumer spending, but store traffic and sales have not returned to levels experienced prior to September 11. Most retailers expect sales to rise only slowly in the weeks immediately ahead, but they do not expect a full rebound in the sales rate. Retailers indicated that their inventories of fall and winter merchandise are already set and are subject to only minor adjustments, but some retailers who need to place orders now for spring merchandise are considering reducing them from levels planned earlier. Auto sales in the region in the days after September 11 were down 20 to 40 percent below the same days last year. Although sales have picked up some since Friday, September 14, dealers do not expect sales to regain the pace set prior to September 11 and they are reducing their orders to manufacturers.

The erosion in consumer confidence in September is a further cautionary sign for retail sales. The Conference Board’s index of consumer confidence for the mid-Atlantic states (Pennsylvania, New Jersey, and New York) fell sharply from 103.1 in August to 85.0 in September, the largest decline in the index since July 1992. The national index fell from 114.0 in August to 97.6 in September. About 85 percent of the households in the national sample were surveyed before the attacks, so the decline in the index reflects weak economic conditions prior to the attacks and, to some extent, the uncertainty about the future course of the economy after September 11.

**Hotel Occupancy Falls Amid Travel Anxiety**

Area hoteliers had been experiencing relatively low-occupancy rates even before the terrorist attacks, expecting the citywide average occupancy rate for the year to be only around 60 percent; 65 percent is considered the break-even point. Area hoteliers are now expecting at least a 5-percentage-point drop in the occupancy rate for the year, to about 55 percent. Nearly all Philadelphia hotel operations have reduced the hours of hourly workers. Hotels in Center City employ over 8,000 workers, and about two-thirds are paid hourly wages. Still, the blow is expected to be less severe in Philadelphia than in other cities, since Philadelphia tends to host a relatively large share of association and regional meetings. Other cities are more oriented toward corporate business.

**Bank Lending Improved Slightly**

Area bankers reported a modest increase in loan demand, prior to September 11, with small gains in most types of lending. Consumer lending was boosted by increases in credit card loans. Other types of consumer lending, such as auto loans and home improvement loans, have declined. Residential real estate lending increased for both refinancings and new mortgages, and business lending increased marginally. Prior to September 11, bankers expected overall loan growth to increase slightly during the remainder of the year. Most bankers expected the growth of real estate lending to moderate, but they anticipated steady gains in personal and business loans.

**Outlook: Downturn in Region’s Economy Will Continue**

Our regional forecasts indicate that the region’s economy is projected to decline on a second-quarter over second-quarter basis (Figure 2). From the second quarter of 2001 to the second quarter of 2002, payroll employment is projected to decline at a rate of 0.6 percent in Pennsylvania, 1.0 percent in New Jersey, and 0.4 percent in Delaware. Initial unemployment claims—another indicator of future employment—are expected to be 6.0 percent in Pennsylvania, 5.4 percent in New Jersey, and Delaware’s 4.4 percent.

In summary, there was little, if any, growth in the regional economy prior to the terrorist attacks. Employment declined, and the region’s unemployment rate, while remaining at relatively low levels, had moved up. Manufacturing continued to decline, and nonresidential construction appeared to have slowed since spring. Retail sales were flat and bank lending increased modestly. The tragic events of September 11 have negatively impacted the retail and travel-related sectors and have increased uncertainty about the future. We expect that the region’s economy will continue to be weak for the balance of this year and during the first half of next year.

Gerald Carlino

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<th>Figure 2</th>
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<td>PA</td>
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<tr>
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