Business conditions in the tri-state region (Pennsylvania, New Jersey, and Delaware) improved in the third quarter, although growth in economic activity has not been robust. Manufacturing continued to expand, although somewhat less strongly than in the second quarter. Retail sales increased slightly. Residential real estate sales remained brisk, but there has been a decline in residential construction. Demand for commercial real estate continues to be slack. Employment in the three states of the region increased in the third quarter, but the gain was less than in the second quarter. The Philadelphia Fed is forecasting a pickup in employment growth during the next four quarters in the three states and further declines in unemployment rates.

Manufacturing Growth Continues
Activity in the region’s manufacturing sector continued to expand in the third quarter. However, the number of firms reporting month-to-month improvement in business declined during the quarter. In July, 47 percent of the manufacturing firms participating in the Philadelphia Fed’s Business Outlook Survey reported improvement in general business activity. Only 37 percent reported improvement in August. In September 30 percent reported improvement. Nevertheless, more firms continue to report improving conditions than deteriorating conditions (Chart 1). On balance, firms in the survey have reported advances in activity each month since May 2003.

The area’s manufacturers are still seeing increased demand for their products, as the number of firms reporting gains in shipments and new orders exceeds the number of firms reporting declines (Chart 2). During the third quarter, growth in demand was especially notable among makers of electrical equipment and firms that produce building materials and wood products used in construction. High rates of home building in the region and throughout the nation have bolstered demand for the products of many of these firms. However, the pace of home construction is not likely to continue to rise, and there have been some recent signs that it might be slowing (see below).

Area manufacturers continued to report rising prices for industrial commodities in the third quarter, and they raised prices for their own products as well. Rising prices for metals, plastics, and fuel were frequently mentioned by manufacturing firms as well as firms in other industries. The rising cost of employee health care was also mentioned widely by manufacturers and other firms in the region.

Area manufacturers expect continued increases in activity (Chart 3). Half of the firms that were polled in the September survey forecast that business will rise during the next six months, and less than one in 10 expect business to slow.

Retail Sales Advance Slowly
Retailers in the region generally indicated that sales moved up in the third quarter compared with the same period a year ago. However, most reported that their year-over-year gains had slipped compared with the increases they made in the first and second quarters. Despite the general slackening in retail sales growth, stores in the three-state region that specialize in luxury goods and higher-priced apparel have had strong growth this year, and that growth continued in the third quarter. Luxury goods retailers in most parts of the country have posted large annual increases in sales so far this year.
Retailers attributed some of the slowing in sales growth during the summer to unseasonably mild weather that lessened the buying of fans, air conditioners, warm weather apparel, and other seasonal merchandise. Some stores were left with excess inventories of summer merchandise, and they cut prices on these goods to clear them out. In contrast, sales of back-to-school merchandise and fall clothing were generally in line with merchants’ expectations.

The region’s retailers generally expect sales in the fourth quarter to be above sales in the same quarter last year, but they do not anticipate large gains. Store executives noted that there is an absence of new products to stimulate overall consumer demand. They also believe that slow employment growth is prompting cautious buying by consumers. With only modest sales growth in most retailers’ forecasts, some retailers have postponed plans to open new stores.

Auto sales in the region slowed during the third quarter. Dealers noted relatively weaker sales for some domestic makes compared with most imports, but a slackening rate of sales appeared to be affecting nearly all brands. Inventories have risen above desired levels, and dealers were trimming orders to manufacturers as the quarter ended.

Residential Real Estate Indicators Are Mixed

Residential real estate activity remained brisk during the third quarter in the region, as it did throughout the nation. The pace of home construction in the region during the third quarter was above the rate for the same period last year. However, building permit issuance declined through the quarter in Pennsylvania and New Jersey but increased in Delaware (Chart 4). For the region as a whole, permits were down 12 percent from the second quarter. Although new home sales appeared to be slowing for many builders in the region, they generally indicated that prices have not fallen; rather, in many popular areas new home prices continued to rise during the quarter.

Residential real estate agents in the region saw mostly steady sales of existing homes during the third quarter, at a rate above the sales pace during the third quarter of last year. House price appreciation has been strong. The latest data (second quarter 2004) from the Office of Federal Housing Enterprise Oversight (OFHEO) indicated year-over-year price increases for existing houses of 13 percent in New Jersey, nearly 12 percent in Delaware, and 9 percent in Pennsylvania (Chart 5). These increases rank New Jersey eighth, Delaware 12th, and Pennsylvania 19th among the 50 states and the District of Columbia in house price appreciation. Price appreciation (year-over-year) during the second quarter was faster than in the first quarter for Pennsylvania and New Jersey, as it was for the nation as a whole. Price appreciation in Delaware was virtually unchanged from the first quarter to the second quarter. Real estate agents in the region noted some slowing in price appreciation for homes in high price ranges during the third quarter. However, they did not observe a sharp drop in appreciation generally. They attributed strong prices to the fact that the number of existing homes for sale in the region has not been excessive in relation to demand. The region’s supply-demand balance contrasts with rising inventories of homes for sale in some parts of the nation, especially in the West.

Commercial Real Estate Remains Soft

Office vacancy rates at midyear showed little change from the beginning of the year (Chart 6). Effective rents remain
under downward pressure as landlords offer incentives to attract and retain tenants. Demand for space has edged up in some markets in the Philadelphia suburbs, although for the suburbs as a whole it declined slightly. The vacancy rate for the Philadelphia central business district has been rather steady. Vacancy in the Wilmington, Delaware, area has declined somewhat. During the third quarter, commercial real estate firms in the region reported that office leasing activity was growing slightly, although the increase in rented space has been small. Vacancy rates for industrial buildings have increased and rents have eased in most parts of the region. However, some areas of strong demand have emerged recently, particularly for warehouse and distribution facilities in central New Jersey, the Lehigh Valley, and the Interstate 81 corridor in Pennsylvania.

**Employment Rises, but Slowly**

Employment increased in the third quarter in each of the states, as it did in the nation, but the growth rate slowed from the second quarter (see Table 1 on page 4). Quarterly changes in employment were slight, although they varied among the major industry supersectors defined by the U.S. Bureau of Labor Statistics. The largest percentage increases were in natural resources and mining in the nation and in Pennsylvania, construction in New Jersey, and leisure and hospitality in Delaware. The largest percentage decreases were information services in the nation, manufacturing in Pennsylvania and Delaware, and trade-transportation-utilities in New Jersey.

Employment has been slow to recover both nationally and in the three states since the end of the recession in November 2001 (Chart 7). National employment turned up in July 2003. The turnaround in New Jersey and Delaware was earlier, in April 2003, although there have been some months of declining employment in both states since then. Employment in Pennsylvania began to recover steadily in April 2004, later than in the nation, New Jersey, or Delaware. Since the end of the recession, employment has advanced 0.5 percent in the nation. Employment has increased 1.3 percent in New Jersey and 0.7 percent in Delaware. Pennsylvania’s employment rate has yet to rise above its level at the end of the recession.

**Modest Gains Are Forecast**

The consensus in the region’s business community is that business activity will continue to improve at a modest rate. Manufacturers forecast increases in shipments and orders during the next six months. Retailers expect sales in the fourth quarter to be above the same quarter last year, although not by much. The outlook for auto sales is uncertain. Dealers anticipate some strengthening in sales as new models are introduced in the fall, but they expect results for 2004 as a whole to be little different than in 2003. Both home builders and residential real estate agents expect the pace of home sales to remain strong unless mortgage interest rates move up significantly. Commercial real estate firms anticipate that demand for office space will move up somewhat in suburban markets as long as regional economic conditions improve, but they expect continuing softness in the Philadelphia central business district. They look for a more widespread increase in demand for industrial space in the months ahead.

The employment outlook is positive; informal surveys of employers indicate that more firms plan to add to employment than to reduce staffing levels in the fourth quarter. The Philadelphia Fed is forecasting increases in employment in each
of the three states of 1.5 to 2.0 percent from the second quarter of this year to the second quarter of next year. This represents a 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*

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* Percent change from previous quarter. **All numbers reflect two months of data.

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**Table 2**

**Regional Forecast**

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

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