



September 3, 2003

## Summary of Commentary on Current Economic Conditions by Federal Reserve District

### Summary

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Prepared at the Federal Reserve Bank of Boston and based on information collected before August 25, 2003. This document summarizes comments received from business and other contacts outside the Federal Reserve and is not a commentary on the views of Federal Reserve officials.

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Reports from the twelve Federal Reserve districts indicate that the economy continued to improve in July and August. Eleven districts say that activity levels increased during the summer. In some districts, improvement occurred in selected sectors, and in others, it was broad-based. Even in the Dallas district, where activity remains generally weak, contacts are said to be more optimistic.

Consumer activity showed improvement in most districts. But Kansas City, Philadelphia, and Boston noted that the increases in retail sales were slight or modest, and New York indicated retail results were better in July than August (partly on account of the August blackout). And retail sales were weak or softening according to respondents in the Cleveland and St. Louis districts.

Ten districts report increases in manufacturing activity. The exceptions were Dallas, where there was little change, and Richmond, which reports that manufacturing weakened. District reports on nonfinancial services firms--temp agencies, software and IT companies, or trucking and shipping--mostly indicate activity increased during the summer months. Among districts reporting on bank lending, a majority cite increases. Most districts report strong housing markets and weak commercial real estate markets, with the latter showing scattered signs of improvement.

Business reports from the New York, Cleveland, Atlanta, Chicago, and Dallas districts mention the mid-August blackout. While respondents note a comprehensive assessment is premature in this round of information-gathering, the effects were generally small. Even where firms were closed for several days, affected contacts suggest they are not anticipating difficulties in making up for lost production or shipments.

### Labor Costs and Prices

Labor markets remain slack across the nation, with few reports of occupational shortages. Employers in a number of districts indicate that wage increases, when they occur, are modest, but the rising cost of benefits--notably health insurance--has raised compensation

costs.

Although districts note price increases for natural gas, gasoline, insurance, tuition, semiconductors, and pharmaceuticals, most product prices are reported to be stable or lower, as businesses say they cannot pass along these or other cost increases to their customers. The dominant price pressures are downward according to reports from Boston, New York, and Chicago, notwithstanding a few manufacturing respondents in Boston and Chicago who indicate they have raised selected prices by small amounts; Dallas reports that manufacturing prices are falling. San Francisco cites "very little upward movement" in the prices of final goods and services, while Minneapolis reports that price increases are generally modest and manufacturers expect prices to remain level for the remainder of the year. Similarly, retailers in the Kansas City district expect little change in prices in coming months.

### **Retail and Tourism**

In most districts, retail sales improved at least modestly in July and August. Contacts in New York report that sales were generally above plan in July, while August reports were mixed, with the blackout having adverse effects on some stores. Respondents in Philadelphia note that sales improved in August from July, while retail revenues are said to be down slightly in St. Louis. Reports were mixed in the Cleveland district, though sales were down compared to the same period last year.

Among categories, the Boston, New York, Philadelphia, Cleveland, Atlanta, Chicago, and Minneapolis districts report reasonably strong demand for back-to-school merchandise, with Philadelphia, Minneapolis, and Kansas City noting a sales up-tick particularly in back-to-school apparel. Home furnishing sales are reportedly up in the Boston, New York, Philadelphia, Cleveland, and St. Louis districts. Appliance sales improved in New York, St. Louis, and San Francisco.

District reports on automobile sales are mixed. Contacts in Boston, Philadelphia, St. Louis, Kansas City, and San Francisco note rising auto sales over the summer, while sales in Dallas are said to be generally flat. Overall car sales are down compared to a year earlier in the Cleveland district, though used car sales continue to increase. Reports from contacts in Atlanta and Chicago were mixed, although both districts report a pickup in sales of light vehicles. Auto dealers in some districts have increased incentives to reduce 2003 inventory as they head into the new model year.

Travel and tourism reports are mixed for July and the first half of August. Overall tourism levels are below a year ago in the Atlanta district, but drive-to tourist destinations continue to perform better than those relying on air traffic. Manhattan hotels note fairly strong business in July and early August. Tourism was generally flat in the Chicago district, and reports are mixed in the districts of Minneapolis and Kansas City, as business in some areas was hindered by forest fires. Contacts in San Francisco report slight improvements in late July and August, with hotel occupancy rates rising in some areas.

### **Manufacturing and Related Services**

Manufacturing activity is reported to be improving slightly to moderately in 10 of the 12 districts. New York, Cleveland, Kansas City, and San Francisco cite continuations of the upward trends in production or orders observed in the spring and early summer. Chicago notes widespread up-ticks in key manufacturing sectors, and Philadelphia finds that

increases in shipments and orders are spreading. Most of the remaining districts characterize the improvements as selective. By contrast with the prevailing tone, Dallas says that manufacturers continue to report tough conditions, and Richmond indicates that manufacturing activity has weakened somewhat.

Various districts report solid or strengthening demand for autos and auto parts, high tech equipment, semiconductors, pharmaceuticals, and building materials. According to reports from Philadelphia, Chicago, and San Francisco, the improvement in manufacturing extended to a pickup in demand for machine tools and industrial equipment. Boston notes rising demand for military goods and stabilizing demand for commercial aircraft, while St. Louis indicates that firms in the helicopter and aerospace industries are expanding. On the other hand, markets for paper, chemicals, textiles, and furniture were reportedly soft or softer than in the recent past, and overall steel demand remains muted.

Manufacturers are reportedly facing rising costs for energy and insurance, but materials costs mostly remain contained. Several districts cite new opportunities for manufacturers to raise prices or trim discounts slightly for selected products. However, competitive pressures or weak demand continue to cause other selling prices to hold steady or fall.

Manufacturing labor demand appears to be firming. A majority of districts indicate scattered reports or projections of longer work hours and selective hiring, and several report that layoffs are becoming less frequent. Most districts commenting on capital spending indicate that manufacturers' plans remain cautious, although the majority of contacts in the Philadelphia and San Francisco districts plan increases.

Manufacturers generally expect that their production volumes will increase somewhat during the remainder of 2003. However, forecasts vary by industry, and some districts indicate that their contacts are planning conservatively in light of uncertainties about the economic recovery.

### **Non-Financial Services**

Non-financial services firms in the Boston, New York, Cleveland, Richmond, Atlanta, Dallas, and San Francisco districts report higher demand during the summer than a year ago. For software and information technology firms in both the Boston and San Francisco districts, revenue and employment levels were flat or slightly higher than a year earlier. In Boston, a few companies that had considered layoffs in the first quarter have, in fact, begun to hire. San Francisco technology respondents report slight demand growth, although sales of telecommunications services were soft.

Temporary employment firms in the Boston, New York, Richmond, Chicago, and Dallas districts report modest demand growth in the second and early third quarters. Respondents said they are optimistic, believing recent improvements in demand reflect more than just seasonal trends. A large New York firm reports a lull in temp hiring in early August, but expects a rebound after Labor Day, noting that the pace of layoffs in the district has abated noticeably in recent months. The Dallas and Boston districts cite signs of increased demand for temp workers in technical areas like software, electronic assembly, and technical support.

Trucking and shipping contacts from the New York, Richmond, and Dallas districts report total volume is higher than a year ago, with a pickup in activity in July and August. Demand for transportation services improved this summer, according to reports from San Francisco

and Dallas districts.

### **Banking and Financial Services**

The majority of districts reporting on bank activity registered a modest pickup in lending in late July and August. Overall lending was up in the Cleveland, Dallas, Kansas City, New York and Philadelphia districts, but deteriorated in the Atlanta, Chicago and Richmond districts due to weak mortgage refinancing activity. As thirty-year mortgage interest rates hit 6 percent in August, some districts tallied mortgage lending declines, while others scored gains as borrowers reportedly hurried to secure mortgage financing in expectation of higher interest rates.

Business lending increased in the Chicago, Cleveland, Dallas, and San Francisco districts, but Atlanta, Richmond and St. Louis saw some decline. Richmond respondents remained pessimistic about the possibility of an upturn, while Chicago and San Francisco report growing demand by small and medium-sized firms. While business loan quality generally held steady, Cleveland and New York saw slightly higher delinquency rates for commercial and industrial loans; by contrast, the quality of consumer credit remained largely unchanged across districts.

### **Construction and Real Estate**

Residential real estate activity remained strong in most districts in July through mid-August, with some contacts reporting all-time sales highs. Respondents in the Chicago, Cleveland, Kansas City, Minneapolis, Philadelphia, Richmond, St. Louis, and San Francisco districts report that overall sales were strong in recent weeks. Dallas indicates that real estate markets "improved" in July and early August, but that the industry "remains very competitive, restraining price increases." In contrast to most districts, real estate contacts in Atlanta report a "slight weakening in overall sales growth, especially at the higher end;" some of this weakness they attribute to unusually wet weather over the summer months. Contacts in the Chicago, Dallas, Kansas City, New York, Philadelphia, Richmond, and San Francisco districts say that the recent upturn in mortgage interest rates prompted a rush to complete sales of both new and existing homes in August. Contacts in Atlanta anticipate some continued slowing through the end of the year as a consequence of rate increases.

Although commercial real estate markets remained lackluster in most districts in July and early August, scattered signs of improvement were reported. Overall conditions are "soft" in Chicago, "weakened" in Kansas City, "sluggish" in Minneapolis, and "lagging" in St. Louis. Boston reports that commercial real estate markets are "holding steady" and Richmond cites "flat" conditions. By contrast, New York respondents note continued improvement, particularly in areas of Manhattan. Atlanta cites "small improvements," and Dallas reports signs of optimism. Most districts report high vacancy rates and some edged higher, but New York cites moderate declines in vacancies, led by strong leasing activity in the Class B segment. Looking forward, contacts in several districts indicate they expect continued weakness until employment growth improves.

### **Agriculture and Other Natural Resources**

Unfavorable weather--too much rain in the East and too little in the Midwest and Southwest--is delaying harvests and damaging crops and pastures in parts of many districts. Contacts across wide areas expect reduced yields for corn, soybeans, and small grains as well as for some more localized products. However, in the Atlanta and St. Louis districts, the corn and soybeans are reportedly in generally good condition. As a result, Atlanta

growers are said to be in a position to increase exports to drought-stricken Europe. San Francisco contacts also note strong export demand. In the hot, dry weather, pastures are reportedly deteriorating and livestock is coming under stress, especially in parts of the Minneapolis and Kansas City districts and, to a lesser extent, in the Dallas district. While contacts in Dallas, Kansas City, and San Francisco describe cattle prices as steady or strong, potentially boosting profits, the need for supplemental feed is rising in some areas, and bankers in the Kansas City district do not expect borrowers to fully recover recent years' losses. Similarly, while some lenders in the Minneapolis district expect above-average farm incomes in the third quarter, Chicago contacts point to lowered yield prospects and higher input costs and anticipate no improvement in farm balance sheets.

In the energy sector, contacts in the Minneapolis, Kansas City, Dallas, and San Francisco districts report that oil and gas exploration or rig counts are constant, solid, or increasing slightly. San Francisco notes that widespread hot weather and the reduced availability of hydropower have reportedly driven natural gas prices higher in recent weeks, while Dallas indicates that blackout-related and other unplanned outages at refineries have caused spikes in gasoline prices. Kansas City bankers say that demand for loans for gas field equipment and development is strong, while Dallas drilling companies reportedly view prices as high enough to cover capital costs. Still, Dallas energy contacts remain intent on controlling costs and cautious about hiring. Most major iron mines in the Minneapolis district are said to be operating near capacity, but they too have announced efforts to cut costs.

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## **First District--Boston**

Conversations with First District business contacts again have a positive tone. Retailers say sales were up modestly during the summer months, and manufacturers report second quarter demand improvements in selected areas. Temp firms and software and IT companies also see some pickup. Commercial real estate markets are said to be stabilizing. Contacts in all sectors indicate that they remain cautious.

### **Retail**

Most retail contacts in the First District report modest improvements, with increases in sales ranging from 3 to 6 percent compared to a year earlier. Surplus merchandise and discount furniture sales are reportedly slightly ahead of expectations, with furniture sales accelerating in August. Rainy weather is said to have hampered sales in the hardware sector, particularly paint products, in June and early August, while sales in July were up 6 percent year-over-year. Office supply sales continue to build momentum, with increasing demand for durable goods and back-to-school items, as low prices help drive sales. By contrast, sales of graphic art supplies are reportedly below year-ago levels. Automobile contacts indicate sales have continued to exceed expectations, particularly in July.

Most contacts report employment is steady, though two retailers expect their headcount to increase by at least 100 over the course of the year. Some respondents recently implemented annual salary increases, ranging from 2.5 to 3 percent, while the majority report no changes. Vendor prices are mostly stable, with selling prices flat to down. Capital spending plans are mixed among contacted retailers, with about half holding spending steady. New store openings account for most increases, while decreases reflect computer-related cutbacks.

Looking forward, most surveyed retailers anticipate slow sales growth over the next six months. Most contacts express greater optimism about the future of the economy than in the recent past. However, some retailers note concern about high unemployment rates, the possibility of rising interest rates, and the continued threat of terrorism.

### **Manufacturing and Related Services**

Most manufacturing contacts report areas of improved demand in the second quarter but say they are unconvinced that the upturn is sustainable. For half of these firms, sales are up by 2 percent to 20 percent from year-ago levels, with new products and currency translation contributing in some cases. For the other half, year-over-year comparisons are weak, with sales flat to down by as much as 20 percent. Sources of strength include sales to the military and the semiconductor industry. Demand for commercial aircraft also shows signs of stabilizing. By contrast, demand for paper products and furniture is reportedly soft. Contacts continue to cut inventory--in a few cases from problematic levels--and note renewed pressures from retailers trying to reduce stocks.

Manufacturers also report that retailers and other major customers continue to demand price concessions although a few contacts have achieved small increases in selected prices. Downward price pressures reflect manufacturers' excess capacity and customers' increased use of online bidding. With prices for materials, other than petrochemicals, also flat to down year-over-year, respondents plan to improve margins through ongoing efforts to cut production costs.

Labor demand appears to be stabilizing at surveyed manufacturers. A majority reduced employment in recent months, but most hope to avoid further layoffs. A few have increased overtime or are hiring for specific divisions. One noted that experienced engineers are scarce.

A few firms are increasing their capital spending markedly in 2003 from 2002 levels as they "chase" technology or install long planned lean manufacturing systems. But over half are spending "carefully"--below last year, below budget or below norm. Most point to idle capacity.

A majority of contacts express cautious optimism about future prospects, with several noting that the outlook for profits or sales is better than expected recently and may even be improving. However, most view the improvements to date as modest and the challenges as daunting. Thus, they continue to plan conservatively and to hunt aggressively for savings.

### **Temporary Employment**

Respondents from temporary employment agencies in New England report slowly growing labor demand in the second quarter, and a noticeable pickup early in the third. Demand for manufacturing workers remains weak, while demand for technical workers--in telecommunications, software, and electronic assembly--has grown significantly in some cases. Respondents report employment is weaker in Connecticut, Vermont, and some parts of western Massachusetts, while southern New Hampshire and Maine are said to be performing better.

Several staffing companies report that some applicants have received multiple job offers, which respondents interpret as a sign of demand growth. Some contacts report a decline in labor supply, both skilled and unskilled. However, the number of permanent positions

available remains small, with clients still preferring to hire on a temporary basis. Downward price pressure continues, with some companies reducing both bill rates and wages in response. Most respondents express concern about rising costs, particularly for medical and worker's compensation insurance.

Contacts are positive about the remainder of 2003, anticipating modest demand growth during this period. But after a healthy July and August, some respondents say they will wait to see what September has in store before committing to the idea of an economic recovery.

### **Commercial Real Estate**

Commercial real estate markets in New England are holding steady. Contacts report no substantial improvement, but no material deterioration either. High office vacancy rates continue to prevail throughout the region. Even though Boston experienced positive market absorption in the second quarter for the first time in over two years, the area's vacancy rates increased as a result of new office space added to the market. Office rents continue to decline in the Boston area and are "nowhere near building replacement cost." Consequently, new construction is being put on hold until it becomes cost effective, which will likely take "a long time." Activity levels are low in all markets, although some contacts attribute that to usual seasonal slowdowns and anticipate more activity in the fall. Others expect the high vacancy rates to persist for quite a while, insisting that substantial employment growth is necessary to improve conditions in commercial real estate markets.

### **Software and Information Technology Services**

Contacts cite renewed optimism in the software sector, with most firms recording either revenue gains or no deterioration from first quarter to second. The majority of contacts, even those with flat current results, are encouraged by pipeline activity, since software sales are typically stronger at year end.

A few companies that were struggling to avoid layoffs in the first quarter are now beginning to hire; however, one contact reports a 10 percent layoff. Capital spending across the sector is still uneven, with some companies spending substantial amounts on technology and others freezing expenditures until the end of the year.

The outlook is beginning to change from flat to positive in the near term as contacts throughout the software and IT sector are buoyed by recent inquiries. Respondents report increased interest in custom applications and banking software.

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## **Second District--New York**

The Second District's economy has given mostly positive signals since the last report. The mid-August power outage evidently had a minimal effect on overall economic activity-some impact was reported on retailers and contract employers. Retail sales, which were above plan in July, were close to plan, on balance, in the first three weeks of August; inventories were generally reported to be at desired levels. Manufacturing activity continued to improve in July and early August, and there was a noticeable pickup in port traffic.

Housing markets have continued to show strength, although some contacts view brisk summer activity as an artifact of rising mortgage rates. New York City's office market continued to improve in July, with particular strength in the Class B segment, and city hotels

report increased business. Finally, bankers in the district report stable loan demand, little change in credit standards, and increased delinquency rates on commercial loans but decreased rates on home mortgages.

### **Consumer Spending**

Major retail chains report that sales in the District were generally above plan in July, but were more mixed in the first three weeks of August. Three retail chains report that the blackout adversely affected sales. One reports that sales are ahead of plan despite the outage, but the other two describe sales as slightly below plan, primarily due to the outage, and do not expect all of the shortfall to be made up by the end of the month. Overall, year-over-year changes in comparable-store sales ranged from up 2 percent to up 7 percent in July, and from down 3 percent to up 6 percent in August. In general, sales of back-to-school merchandise were described as strong—women's apparel, lawn and garden, and home furnishings and appliances were also reported to be especially brisk. The pricing environment remained weak. Most retailers say inventories are in good shape.

Manhattan hotels report that business was fairly strong in July and early August: while room rates were down about 3 percent from a year earlier, occupancies were up nearly 5 percent. As a result, total revenues were up, on a year-over-year basis, for the first time this year. While two major New York City hotels had to evacuate during the blackout, most were fully occupied—some offered discounts and even free rooms.

### **Construction and Real Estate**

The housing market has remained robust in recent weeks. New Jersey home-builders report that housing demand has been unusually strong for August, as rising mortgage rates have reportedly spurred a sense of urgency among buyers. Construction is lower than in 2002, mainly due to a dearth of available land, and selling prices are said to be leveling off but still higher than a year ago. Buffalo-area realtors indicate that home sales were strong in July and that selling prices were up roughly 10 percent from a year earlier. Across most of New York state, compared with a year earlier, there were fewer sales transactions but median selling prices posted double-digit gains. Manhattan's co-op and condo market was described as unusually busy during the first half of August; selling prices were steady but still noticeably higher than a year ago. Apartment rental markets have been mixed but generally sluggish. In Manhattan, while rents remain moderately below a year earlier, they are said to have firmed modestly since the end of 2002. In contrast, New Jersey's Hudson riverfront rental market has experienced persistently high vacancy rates and little or no rebound in rents.

Manhattan's office market showed continued improvement in July, led by strong leasing activity in the Class B segment, largely from small to medium-sized firms. Overall, vacancy rates declined moderately in Midtown and Midtown South; Lower Manhattan's rate inched up but is still substantially lower than at the end of the first quarter. Asking rents appear to have leveled off this year but are still roughly 8 percent lower than a year ago.

### **Other Business Activity**

A major New York City employment agency reports more than the usual seasonal slowing in hiring activity in recent weeks, following a strong June and July, but suggests that the August lull is probably temporary, reflecting a growing trend toward concentrating vacations in August. This contact also notes that the pace of layoffs has slowed noticeably in recent months and anticipates a brisk rebound in hiring after Labor Day. The blackout had a noticeable but short-lived effect on contract employment: lost hours and wages for temp



workers and reduced fees and commissions for the agency.

The manufacturing sector has shown continued positive momentum in July and early August. Our monthly survey of New York State manufacturers shows continued improvement in conditions in early August. Buffalo-area purchasers report a strong snapback in manufacturing-sector conditions in July, following a brief slowdown in June. Similarly, Rochester purchasers report improved business conditions in both manufacturing and other sectors. Finally, New York City area purchasing managers report continued improvement in the manufacturing sector in July; there was some leveling off outside of manufacturing, where New York City respondents had been reporting weakening throughout the first half of the year. Purchasing managers in all three metropolitan areas report an upturn in input prices.

A major freight shipping terminal reports a noticeable increase in volume (mostly imports from Asia) since the beginning of August; total volume is reported to be up roughly 10 to 13 percent from a year earlier, and largely represents holiday-season retail merchandise. Part of the pickup reflects a trend toward more "all-water" services to the East Coast ports from Asia, and is spurring increased warehousing and distribution in New Jersey. The power outage at the port lasted less than four hours and had a minimal effect.

### **Financial Developments**

Small to medium-sized Second District banks report relatively stable loan demand in the latest survey. Demand for residential mortgages was mixed, with nearly half of bankers indicating lower demand, but a similar proportion reporting higher demand. Widespread declines were reported in refinancing activity. On the supply side, over 90 percent of bankers in each category report no change in credit standards.

Interest rates rose for all types of loans-in particular more than three in four bankers report higher rates for residential mortgages, and more than half report an increase in rates for commercial mortgages. However, average deposit rates declined, with over half of bankers reporting lower rates, as opposed to one in six reporting higher rates. Bankers report that delinquency rates increased for commercial and industrial loans but decreased for residential mortgages.

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### **Third District--Philadelphia**

Business activity in the Third District continued to advance slowly in August. Manufacturers reported increases in orders and shipments for the month. Retail sales of general merchandise picked up in August for the usual back-to-school shopping period, although the year-over-year gain appeared to be slight. Auto and light truck sales have been strong as model year close-out promotions boosted the sales rate. Bank lending has been rising slowly, with most of the gain coming from residential lending. Commercial real estate markets remain soft, but home sales have increased. Overall tourism business for the summer season appears to be matching last year's level, but lodging activity is off from last summer.

The outlook among contacts in the Third District business community is for steady or slowly improving conditions. Manufacturers forecast increases in shipments and orders during the next six months. Most of the retailers surveyed in August expect sales to rise

slowly through the fall. Auto dealers anticipate some slippage in sales after 2003 models are cleared out. Bankers expect slow growth in lending as the pace of economic activity in the region gradually rises.

### **Manufacturing**

Manufacturers' shipments and orders increased in August compared with July. More than one in three of the companies surveyed in August reported increases in demand for their products and less than one in five reported decreases. Improvement in business conditions appears to be spreading across the major manufacturing industries in the District. Firms that make products used in residential construction reported increases in orders in August, continuing the strong demand they have had in previous months this year. Manufacturers of industrial equipment, which had experienced generally lackluster conditions for the past 12 months or longer, reported increases in demand in August. There were gains for makers of many industrial products, such as primary and fabricated metals, machinery, and electrical equipment. However, chemical producers and instrument manufacturers reported a falloff in orders in August.

The outlook among the region's manufacturers is positive. Around half expect increases in shipments and orders during the next six months, and less than one in five anticipate decreases. Area manufacturers forecast some increases in employment and working hours, on balance, in the next six months, and they plan to step up capital spending plans moderately.

### **Retail**

Third District retailers generally reported that current dollar sales increased in August from July, although the year-over-year gain appeared to be slight, according to most of the stores surveyed. Sales of back-to-school supplies and apparel have been good, but some women's clothing stores continue to report weak sales. Some merchants said they have seen a pickup in sales due to the federal income-tax rebates, but others said consumers continue to be cautious in their spending. These merchants noted that many shoppers are favoring lower-priced brands and concentrating their buying at discount stores and manufacturers' outlets. Some stores have been left with undesired inventories of summer merchandise, although several noted that warm weather apparel was continuing to sell fairly well, and sales of home furnishings remained healthy.

The consensus among retailers contacted in August is that sales will move up slowly during the fall. Several store executives said they will introduce cold-weather merchandise later than usual this year and keep inventories limited. These retailers said consumers have been showing a greater tendency to delay purchases until their needs are more immediate. Merchants are responding by timing the introduction of seasonal merchandise more closely to the relevant season.

Auto dealers reported generally rising sales during August. Manufacturers boosted incentives to clear out 2003 models as 2004 models arrive. Dealers are taking delivery of new models, and consequently, their inventories are high. In general, dealers expect it will be difficult to maintain the current rate of sales once older model inventories are depleted, but most dealers anticipate a high sales rate for the most popular new domestic cars and trucks and continued strong sales of luxury imports.

### **Finance**

Outstanding loan volume at Third District banks was growing slowly in August. Residential real estate lending continued to move up, mainly for home purchases, while refinancing activity has declined. Consumer credit also increased, although recent gains in most categories of personal lending, including credit cards, have been modest at most of the banks contacted for this report. Business loan volume outstanding has been practically flat, according to bank lending officers. They said most of their commercial and industrial borrowers have not had the increases in business that necessitate expansion.

Bankers surveyed in August expect business activity in the region to move up very gradually, and they expect total lending to rise slowly along with the improvement in regional economic conditions. Some also said they expect at least a slight deterioration in credit quality, unless the recovery in the region's economy strengthens.

### **Real Estate and Construction**

Commercial real estate firms in the Third District reported that overall office vacancy rates have increased in suburban markets, where several new buildings have recently become available with substantial amounts of space not pre-leased. Vacancy rates in suburban markets were estimated in a range of 12 to 24 percent, up around 1 percentage point since the spring. The vacancy rate in the Philadelphia central business district has been nearly steady at around 13 percent, virtually unchanged in recent months. Effective rental rates continued to decline as landlords offer tenant improvement allowances and rent-free periods, and several major tenants have negotiated renewed leases at lower rents. Commercial real estate contacts say office vacancy rates will probably begin to edge down near the end of the year as the number of new buildings becoming available declines.

Residential real estate agents and home builders generally reported that sales have accelerated. They said the recent upturn in mortgage interest rates prompted a rush to complete sales of both new and existing homes. Home builders generally expect sales to remain strong, although some indicated that their backlogs appear to have peaked. Real estate agents expect a strengthening economy to support a fairly good rate of home sales despite higher mortgage rates.

### **Tourism**

Tourism officials in the region reported that tourist and vacation locations have had mixed results this summer. Periods of cool and rainy weather have resulted in fewer visits to beach resorts. Lodging and other business activity in some of these areas have been less than last year. In particular, vacation home rentals have not met expectations. Tourist visits to urban areas have been fairly high. Some museums have broken attendance records, and many summer entertainment programs and performing arts festivals have had high attendance. On balance, it appears that the region's overall tourism-related business this summer will be roughly equal to last year's, but lodging activity will probably be down.

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## **Fourth District--Cleveland**

Most Fourth District contacts reported increased economic activity since the last report, although growth appears to be modest. For the third consecutive report, manufacturers cited steady or improving production and sales. Residential homebuilders reported continued sales growth. Demand for commercial loans increased since the last report, while consumer

loans remained constant.

Reports from other areas of the economy were mixed. Retailers and auto dealers experienced continued slow sales, though these were not necessarily unanticipated. Activity in commercial construction accelerated in parts of the District, but it remained sluggish in others. After a more optimistic report in July, conditions in steel did not show further improvement. Though overall prices of inputs were flat or declining, utility prices rose. Employment levels did not change for most contacts; some added employees, and a few firms reported layoffs. While there is plenty available labor, contacts stated there is less available now than during the same time last year. Rising insurance costs have caused a number of firms to change features in benefits offered to employees, both by passing some costs to employees and curtailing some benefits.

Most contacts in manufacturing, residential construction, banking, and trucking and shipping expect conditions to continue improving throughout the rest of the year, while contacts in steel, commercial construction, and retail were more mixed with regard to continued activity.

This District was affected by the blackout in mid-August. Though most contacts could not immediately discern the total impact, retail and manufacturing experienced the greatest impact as a result of closures. Other sectors of the economy experienced minor or no problems due to the electricity problems.

### **Manufacturing**

Most manufacturing contacts reported continued improving conditions in July and August. However, unlike the previous report, a few contacts did note declines in both production and sales. Overall, both production and sales were higher during this period than in the most recent report and during the same time last year, with nondurable goods manufacturers generally citing more favorable conditions than durable goods producers. Inventory levels were flat during this time period, with idle capacity remaining relatively the same as well. While most manufacturers said they were maintaining their current workforce levels, the proportion of firms reporting new hires was greater than those cutting payrolls. Most contacts still anticipate moderate sales and production growth by year's end.

Auto production fell again at most District plants in July and early August compared with June, but it should be noted that many facilities re-tooled in early July. Regardless, same-model production was about 4 percent lower than 2002 levels. In July, three new models began production in the District. A few facilities reported the use of overtime.

In the steel industry, production was fairly stable between July and August, though there was some mention of increased sales between July and August. However, overall demand was characterized as "soft" in August, and both sales and production levels during this period were substantially down from last year. Inventories are down from a year ago, and firms anticipate holding inventories at their current low level. New orders for steel for the fall are coming at a steady rate, and contacts expect the demand to remain the same till the end of the year. To meet current demand, plants are running normal-to-shortened work schedules. Most contacts have held employment levels constant since the previous report although a few are reducing jobs. Steel prices were mixed, with slight movement in both directions.

Many manufacturers in the areas affected by the blackout were closed up to three days;

however, most firms stated that they were able to tap into inventories and anticipated being able to use overtime production, as needed, to make up for the loss. Manufacturing contacts stated that supply chains were largely uninterrupted and orders were unaffected.

### **Retail Sales**

Economic conditions were again mixed in retailing during July and early August compared to the previous report, with small increases and decreases in sales activity reported. However, all contacts noted sales declines of slightly lower to almost 15 percent down since the same period last year. Discounting and promotional activity continued, as many retailers geared up for back-to-school shopping. Sales were in-line with retailers' expectations, and all contacts reported favorable inventory positions. Though activity in apparel remains generally sluggish, contacts stated that sales of furniture, cosmetics and personal care items, shoes, and career wear (men's and women's suits) were strong during this period. Most contacts are expecting sales to be flat or slightly higher this year relative to last.

Retailers in the District reported electricity-related losses on Thursday, though many were able to open on Friday. Overall impact on the sector is not yet known. Restaurants were particularly hard hit because of the water problems that continued after electricity was restored.

Automobile dealers noted flat-to-declining new car sales throughout the District. Overall sales this period were lower than during the same time last year. Sales continue to be dependent on incentives, though their impact on consumers has deteriorated. Used car sales, on the other hand, continued to increase. New car inventory levels are more favorable than in previous months.

### **Construction**

Continued strong sales were cited by homebuilders in the District, as in last month's report. Growth in sales has continued since the spring and, while not uniform, some contacts cited this period being one of the strongest ever. Sales for most builders are above plans, which anticipated sales increases of about 3 to 5 percent during 2003 relative to 2002.

Commercial building continues to be slow, though parts of the District show signs of improvement. Within the last several weeks in the Cleveland area, the number of new projects in several building segments, including manufacturing, warehousing, and distribution had accelerated. There also appears to be increased activity in the Pittsburgh area, while in the Columbus area and the southern part of the District demand remained sluggish.

### **Trucking and Shipping**

Demand for trucking and shipping held constant again since the previous report, and conditions were flat compared to the same time last year. Consolidation in the industry points to further increases in capacity utilization. Increased demand from retail and consumer goods was reported, while manufacturing demand continues its flat-to-negative trend of recent years. Most contacts anticipate at least limited growth over the next months, though capital expenditures will generally be targeted toward replacing current vehicle stock rather than increasing capacity. The electricity problems delayed some shipments, but due to available capacity the backlog was alleviated within twenty-four hours. Some likened it to a one-day snowstorm.

### **Banking**

Both commercial and consumer loan activity remained steady or increased since the last report. Most contacts reported increased demand for commercial loans relative to both June and the same period last year. Consumer loan activity remained strong because of mortgage refinancing. There was no change in the number of applicants, and reports on the credit quality of applicants were mixed. There were also mixed reports regarding core deposits, with contacts reporting both slight increases and decreases. Business and mortgage loan delinquencies increased during this time period for most contacts. The squeeze on net interest margins continued into this report, as loan rates have adjusted downward and funding rates remained relatively constant. Contacts observed that business confidence has improved, evidenced by interest in borrowing for new capital expenditures, while general consumer confidence has not changed.

During the blackout, many banks lost ATMs and some branches closed, though it was toward the end of the business day, and most areas had power restored by the following morning for business.

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## **Fifth District--Richmond**

Economic growth in the Fifth District picked up in late July and August, although manufacturing activity weakened somewhat. Retailers generally reported higher sales, particularly at automobile dealerships and home improvement stores. Services businesses recorded a noticeable improvement in revenues as well, although employment growth in the sector remained subpar. The District's manufacturing sector wobbled, however, weakened by further declines in production and employment, especially in the textiles and furniture industries. In addition, manufacturers trimmed their forecasts for shipments and capacity utilization for the remainder of the year. In housing, rising mortgage interest rates brought a decline in residential mortgage refinancings, but home sales and housing starts continued to be strong. On District farms, incessant rain delayed small grain harvests and thwarted hay production in some areas, but assisted corn and soybean development.

### **Retail**

Fifth District retailers generally reported higher revenues in the weeks since our last report. Automobile sales were particularly strong--dealers in Virginia and the Carolinas said business was brisk and they expected sales to remain strong through the end of the year. Home improvement stores also fared well--a contact at a Virginia Beach, Va., location noted a "marked improvement" in sales in recent weeks. Reports generally indicated that retail employment was flat. An exception was in Richmond, Va., where retail hiring was in full swing as two upscale malls were slated to open in September.

### **Services**

Contacts at Fifth District services firms reported a substantial pickup in customer demand in recent weeks but only modest increases in payrolls. A manager at a financial services firm in Baltimore, Md., for example, noted that while demand firmed, hiring remained selective. Trucking and transportation firms in Maryland and West Virginia reported increased revenues during the past six weeks, as did a real estate firm in North Carolina. The pickup wasn't felt in all areas of the District, however. Some services businesses in manufacturing areas of North Carolina reported sluggish activity--a financial services firm there reported feeling negative "ripple effects" from weakness in the textile industry.

## **Manufacturing**

District manufacturing activity softened since our last report. Measures of both shipments and new orders moved lower. Textiles manufacturers announced more plant closings and layoffs. Furniture manufacturers also reported layoffs as demand continued to weaken--a contact in North Carolina said furniture retailers were neither ordering stock nor building inventories. Many District manufacturers lowered their sales forecasts for the next six months as demand sagged. Outside of a few reports of higher natural gas prices, overall prices for raw materials and final goods produced were little changed since our last report.

## **Finance**

District loan officers said that loan demand dipped in recent weeks as the demand for residential mortgage refinancings dried up. Thirty-year mortgage interest rates rose above 6 percent in August, taking the steam out of the refinancing activity that had surged in June and July. A mortgage banker in Charleston, S.C., said that while residential mortgage lending was strong early in the summer, refinancings had declined dramatically and lenders' "fortunes have reversed." A banker in Greenville, S.C., added that if mortgage rates remained above 6 percent, refinancing activity would grind to a halt. The demand for commercial loans remained weak and most commercial lenders were pessimistic about a pickup in the near future. In the words of a Richmond, Va., banker, "Businessmen are not convinced the slowdown [in business activity] is over."

## **Real Estate**

Real estate agents across the District continued to report strong home sales since our last report. A realtor in Greenville, S.C., told us that business had been "incredible," adding that 2003 was a "banner year" for sales at his firm. Likewise, an agent in Charlotte, N.C., said sales had been "off the charts" in recent weeks. Most agents contacted stated that the recent increase in mortgage interest rates had sparked higher sales in August as fencesitters bought ahead of possible further mortgage interest rate hikes. Homes priced in the low-to-middle range remained the best sellers, while sales of homes in the upper ranges continued to be sluggish. Home prices remained relatively steady across the District.

Fifth District commercial realtors reported that overall leasing activity was generally flat in recent weeks, although signs of life were emerging in some areas. A realtor in Bristol, Va., noted continued strength in retail and office space leasing around a booming interstate exit in the area. Stronger retail leasing activity was also reported in Charleston and Huntington, West Virginia. A contact in Roanoke, Va., was "extremely encouraged" by a sharp increase in sales of commercial tracts, while a contact in Raleigh, N.C., reported that office space absorption was positive for the first time in five quarters. All the news wasn't upbeat, however. Demand for industrial and warehouse space remained weak across most of the District and construction activity was generally flat.

## **Tourism**

District tourist activity was mixed in recent weeks. Along coastal areas, contacts reported that bookings were somewhat better than a year ago. A manager at a Virginia Beach hotel told us that tourist activity remained strong despite frequent rains in the area. A contact in coastal North Carolina noted that cottage and luxury home rentals were up somewhat but he said that rainy weather had slowed weekend bookings and day trips to the beach. Bookings at mountain resorts were lower, in part because of inclement weather and lingering concerns about the economy and the safety of travel.

## **Temporary Employment**

Temporary employment firms generally reported modest increases in the demand for placements since our last report. A contact in Hagerstown, Md., reported having a "sense" that his customers were getting busier, which he believed would lead to an increased need for temporary workers. Likewise, an agent in Charleston, W.V., said that he had acquired a \$2 million per year contract with a large firm in the area and he expected demand for temporary workers to strengthen further as a result.

## **Agriculture**

Wet conditions persisted in most areas of the District since our last report, delaying harvests of some crops, causing rot and disease in small grains and vegetables and hampering hay production. In many areas of Maryland, North Carolina, and West Virginia, farmers reported that frequent afternoon storms had saturated fields and slowed the tobacco harvest. Excessive moisture caused rot in melons in Virginia and some soybeans in North Carolina. In contrast, corn and soybean crops in Virginia continued to show improvement with few signs of disease. Despite the rains, both the cantaloupe and watermelon harvests were nearing completion in South Carolina.

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## **Sixth District--Atlanta**

Reports from Sixth District contacts pointed toward a modest improvement in economic activity from late July through mid-August. Retail contacts were positive about sales activity and the manufacturing sector displayed some welcome signs of improvement. The pace of factory orders was reported to have increased in some industries, and transportation contacts noted an increase in shipping activity. Despite the recent run up in mortgage rates, single-family construction and sales remained flat to slightly up. Commercial construction was still limited by low demand for new space. Nonetheless, office leasing activity and net absorption conditions continued to improve in most markets. The District's tourism and business travel sectors continued to lag, and higher gasoline prices in August were expected to further dampen travel. The healthcare and education sectors continued to report increased demand for workers, whereas the pace of the layoffs in the manufacturing sector slowed from earlier in the year. The strongest employment reports came from Georgia and Florida.

## **Consumer Spending**

Retail contacts indicated that sales growth during late July and through mid-August improved compared with early July and exceeded year-ago levels on a same-store basis. According to reports, sales have matched or surpassed expectations, and back-to-school sales were generally very positive. Retailers continued to be upbeat about prospects for the remainder of the year. Despite better than expected sales, there were no widespread plans to increase inventory at this stage. District auto dealers continued to report mixed sales results. Disappointing domestic car sales were offset by strong results for light trucks and for non-U.S. brands.

## **Real Estate**

According to reports from single-family homebuilders, new home construction and sales from late July through mid-August was flat to slightly up compared with last year. However, wet weather continued to dampen activity in some areas. For instance, one report noted that



Atlanta has had one of the wettest summers on record. Reports from District real estate agents noted a slight weakening in overall sales growth, especially at the higher end. Although contacts anticipated some continued slowing through the end of the year as a consequence of higher mortgage rates, a dramatic drop-off in activity is not expected. The region's commercial real estate markets continued to show small improvements, especially regarding leasing activity and net absorption. However, weak demand for new space persisted in most markets.

### **Manufacturing**

Factory activity improved slightly since early July, but most firms remained reluctant to add to payrolls or purchase new equipment. Reports from lumber mills, high-tech producers, and building material suppliers indicated increased shipping volume and orders. Chemical industry contacts reported steady demand. Production levels are increasing in the region's auto industry because of newly opened auto assembly plants. However, new orders for apparel and textile producers continued to suffer because of sluggish demand and foreign competition. Consistent with the reports of increased production overall, business conditions continued to improve for most shipping contacts. However, some have noted that the recent blackout disrupted services to some manufacturing customers.

### **Tourism and Business Travel**

Drive-to tourist destinations continued to report better performance than those relying on air traffic but overall tourism activity remained subdued. Resort tax collections were down from year-ago levels for some Florida counties, and international tourism remained weak. Along the Mississippi Gulf Coast, casino gross gaming revenues were down from a year earlier. Throughout the District, hotels catering to business travelers continued to report low-occupancy levels.

### **Financial**

Mortgage refinancing declined and applications for new mortgages slowed in most parts of the District in August. Contacts continued to indicate that problem loans and delinquencies continued to be manageable. Overall business loan activity remained lackluster. Borrowing by small businesses remained down, except for activity related to the housing industry, such as building material suppliers or furniture dealers.

### **Employment and Prices**

There were mixed reports on labor markets in late July and August. The healthcare and education sectors continued to add to permanent and temporary staffing levels. Layoffs in some struggling manufacturing industries persisted, as did reports of weak demand for temporary office staff. Most reports continued to indicate that businesses did not expect to substantially change their hiring plans over coming months. Employment reports from Florida and Georgia were generally stronger than other parts of the District. Increased costs for insurance and pharmaceuticals continued to be reported, and higher gasoline prices in August were expected to dampen travel-related activity in the District. Discounts by hotels and cruise lines remained in effect in an effort to stimulate activity.

### **Agriculture**

A series of new tropical storms brought significant rainfall to much of the District in July and August. The rains slowed pesticide spraying in parts of Florida and Georgia, but no major damage was reported. Generally, cattle and pastures were in good condition in most areas. In Georgia, crop conditions were favorable, particularly for the soybean and corn,

which are expected to have record yields this year. These District crops could benefit from increased export demand as a consequence of severe drought conditions in parts of Europe.

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## **Seventh District--Chicago**

Seventh District economic activity improved in late July and the first few weeks of August, with contact reports suggesting that gains, while modest, were broad based. The power "blackout" of mid-August forced many Michigan businesses to close for a day or two, but contacts were confident that any lost production and/or sales would be quickly recouped. More generally, both consumer and business spending picked up in late July and August, though households and firms remained cautious. Home sales rose as buyers rushed to lock in interest rates, while commercial real estate markets remained weak. Manufacturing activity also increased slightly, with widespread improvements in key industry segments. Overall lending activity slowed, as mortgage applications dropped sharply. Prices firmed for some producer goods and services, but fierce competition kept retail prices in check. Little precipitation in late July and early August lowered expectations for the corn and soybean harvest, dampening hopes of expanded capital spending by farmers and boosting the likelihood of an increase in operating loan renewals and extensions.

### **Consumer Spending**

Consumer spending firmed in late July and the first few weeks of August, although many contacts (retailers, auto dealers, restaurateurs, etc.) indicated that gains in the Midwest again lagged the rest of the nation. Retailers were generally pleased with sales results and said that back-to-school promotions have been very successful. Inventories were mostly in line with sales expectations, and at least one national retailer was planning to boost year-over-year stocks in anticipation of stronger sales ahead. Entertainment spending was mixed. One contact in casual dining said that sales were "okay," but the industry did not see an expected boost from tax rebate checks. Ticket sales for one regional theater chain were down from a year ago, though our contact indicated that the decline reflected product offering more than consumer demand. District auto dealers said that light vehicle sales picked up in late July, particularly in the last few days. Showroom traffic and sales slowed in early August, but recent trends suggest that consumers have been waiting until the end of the month to buy, believing that is when they will get a better deal. Several dealers noted an increase in service sales. Tourism spending was generally flat in most of the region, although it seemed to improve in the Chicago area.

### **Business Spending**

While most firms remained cautious, business spending appeared to pick up slightly. Labor demand was still soft, but was said to be firming in some areas and industries. Reports of manufacturing layoffs became less frequent in recent weeks, and there were even scattered reports of increased hiring. One large temporary help firm noted that the number of workers on assignment was flat through mid-August, but average hours on assignment edged up, rising to the highest levels in four or five years. A smaller staffing services firm also noted "a trickle" of direct hire orders over the last two months, something that this firm had not seen in two years. Capital spending remained soft, although we continue to hear reports of spending for maintenance, repair, and replacement of equipment. While many business contacts noted a general improvement in economic conditions, they suggested that capital spending would remain subdued until cash flow improved. Reports on other business

spending (such as for advertising and travel) were mixed.

### **Construction and Real Estate**

Home sales rose in much of the District in July and early August, while commercial real estate markets remained weak. Realtors and builders in some areas said that July was a "barn-burner month" for home sales, with many reporting all-time sales highs for the month. Several contacts said that rising mortgage interest rates helped boost home sales as potential buyers rushed to close deals, fearing rates would move higher. A few contacts noted that traffic and sales activity slowed modestly in mid-August, but they did not think it was the start of a trend. Realtors and builders were still optimistic about prospects for the fall, as long as interest rates did not rise substantially further. Commercial real estate activities remained soft, and contact reports suggested that markets had not changed much in recent weeks. Demand for office space was still weak. One contact attributed the softness to slow job creation, stating "if tenants aren't adding bodies, they don't need more space." With the lack of payroll employment gains, many property holders again pushed back their timetable for a recovery in office markets.

### **Manufacturing**

Seventh District manufacturing activity picked up modestly in July, with gains broad based across key industry segments. Automakers said that light vehicle demand was solid through mid-August with sales nationwide running ahead of July's pace, and just below a year earlier (which was an exceptional month). While many in the industry expect demand to remain firm, inventories were still slightly high and automakers had not changed production schedules. A major appliance manufacturer reported that shipments were strong in July and off to a good start in August. Producers of heavy trucks and equipment noted an increase in new orders and production in July. Contacts in the machine tool industry said that new orders had firmed, and that the increase in demand was widespread. Domestic steel makers benefited from a sharp drop in steel imports, which some contacts attributed to a weaker dollar.

### **Banking and Finance**

Overall lending activity appeared to slow somewhat, due in large part to a drop in mortgage lending. Many bankers noted a sharp decline in mortgage refinancing activity as interest rates on 30-year fixed-rate mortgages rose by more than 100 basis points since mid-June. Mortgage applications for new purchases edged down, but held at high levels. Bankers noted that more homebuyers were opting for variable rate mortgages. Margins on mortgage loans narrowed in July and August, as competition for a smaller pool of potential borrowers intensified. Overall credit quality on household loans was good, with little change from our previous report. On the business side, some bankers indicated that loan demand firmed in recent weeks, albeit slightly. For the banks that saw improvement, the gains were generally in the small and middle-market business segments. One lender said that business loan volumes should begin to rise in the third and fourth quarters as businesses "emerge from survival mode." Overall business loan quality was still good, and some bankers indicated that the number of loans on watch lists continued to trend down.

### **Prices and Costs**

Some manufacturers (including steel, gypsum wallboard, and heavy equipment producers) suggested that firmer demand was allowing them to raise prices and/or trim discounts. Over the last few years, prices had been eroding more or less steadily for many manufacturers due to a combination of weak demand, a strong dollar, and intense competition. Manufacturers

of a few consumer durables, such as appliances and light vehicles, said that product prices continued to slide. Fierce competition kept retail prices in check, as many retailers continued to use steep discounts to move merchandise. Some manufacturers said that natural gas prices were raising the costs of production, and consumers faced rising prices at the gas pumps. One national dining chain also suggested that increases in state and local taxes were squeezing profits. Contacts suggested that wage gains continued to moderate, but higher benefits costs (particularly for health insurance) kept overall employment costs rising.

### **Agriculture**

Crop conditions have deteriorated in much of the region, which has lowered expectations for corn and soybean yields. The lack of timely moisture in most areas stressed crops, although the region escaped prolonged extreme heat. Soybeans were also stressed by aphids, forcing additional spraying to prevent further yield losses. A later frost could give crops much needed time for improved yields, especially in the eastern portions of the District where planting delays were longest. Given lowered yield prospects and higher input costs, most farm balance sheets are not expected to improve this year, and some may worsen. As a result, contacts anticipate increased operating loan extensions and renewals this winter. Moreover, a hoped-for increase in capital spending by farmers is now unlikely.

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## **Eighth District--St. Louis**

Economic conditions in the Eighth District, particularly in manufacturing, have improved moderately since our last report. Recently, there have been announcements of plant openings, product line expansions, increased spending on research and marketing, and new jobs created. Retail sales in July and August were down slightly, on average, from a year ago. Auto sales over the same period rose slightly. Over the past three months, District banks have seen almost no change in lending activity. Residential real estate markets in the District continue to do well, while commercial markets are still lagging behind.

### **Consumer Spending**

Contacts reported that retail sales in July and August were down slightly, on average, from year-earlier levels. More than 50 percent of the retailers surveyed noted that sales levels met their expectations, although, given the slow economy, they were not expecting much growth. About 25 percent of contacts reported that sales levels were below what they had anticipated. Food, apparel, shoes, home items, and appliances were strong sellers, while gift items, jewelry, specialty, and luxury items were moving more slowly. More than 60 percent of the retailers surveyed noted that inventories are at desired levels, while 25 percent of contacts reported excess inventories. A few contacts indicated continuing plans for merchandise discounting. Retailers remain cautiously optimistic about the next two months, with 95 percent of contacts expecting sales to remain flat or slightly above 2002 levels.

Car dealers in the District reported that, on average, sales in July and August were slightly up over year-earlier levels. Most contacts attributed this to strong manufacturer incentives and heavier advertising, as more than 60 percent of them noted that their use of rebates has increased. About 40 percent of contacts reported that sales of new cars have increased, while 20 percent of the car dealers surveyed reported an increase in low-end vehicle sales. About 40 percent of contacts reported that their inventories are at desired levels, while another 40 percent noted that their inventories are too low because of sales growth and the expectation

of the new models towards the year-end. About 60 percent of the dealers surveyed expect sales to increase slightly over last year in the next two months.

### **Manufacturing and Other Business Activity**

The Eighth District's manufacturing sector appears to be getting stronger. Plant openings, product line expansions, increased spending on research and marketing, and new jobs have been reported. Companies in the helicopter, boat, auto and auto-parts, aerospace, pharmaceutical, fiber, wiring, communication, energy, food, appliances, stationery, and printing industries have announced such moves. Firms in the communications, pharmaceutical, and medical products industries have reported higher sales volumes and increased earnings. There has also been an increase in acquisition activity, especially in the magnesium, energy, foam material, and food industries. Business optimism is the highest it has been over the past 18 months; however, many contacts note that the increased costs of health insurance, severance packages, litigation, and natural gas prices have slowed the recovery of manufacturing employment. Despite the positive outlook, there have also been several announcements of plant closings, downsizing, layoffs, higher operating costs, low sales volumes, and negative profits. Affected industries include textiles, bedding, chemicals, wiring, furniture, metalworking, lubrication, and utilities.

### **Real Estate and Construction**

Residential sales are still doing well in most of the District. In June, Memphis year-to-date home sales were 10.3 percent higher than in June 2002. Over the same time period, Little Rock had a 6.1 percent increase and northern Kentucky had a 14.0 percent increase. Contacts report that new home sales continue to be strong despite recent mortgage rate increases. June year-to-date single-family housing permits were up in most of the District's metropolitan areas from last year. Permit levels increased by 22.8 percent in Little Rock and by 5.6 percent in the Memphis area, but decreased by 5.0 percent in the St. Louis area. Commercial real estate markets are still lagging behind residential markets in most of the District. The St. Louis area office vacancy rate was 17.3 percent for the second quarter of this year, up from 16.5 percent in the first quarter; the industrial vacancy rate remained stable at 7.9 percent. The second quarter industrial vacancy rate in Louisville was 21.0 percent, and the midyear office vacancy rate was 20.2 percent---a modest increase when compared with the same period one year ago. Although industrial vacancy rates have also been increasing in Little Rock and in Tupelo, Mississippi, contacts in those two cities report that construction is picking up. Commercial construction is also doing better in other parts of the District, including several new projects being undertaken in Danville, Kentucky.

### **Banking and Finance**

A recent survey of senior loan officers at a sample of District banks indicates little change in overall lending activity over the past three months. Banks' credit standards for commercial and industrial (C&I) loans remained generally unchanged for large and small firms. The responses about the change in demand for C&I loans over the past three months varied from unchanged to slightly weaker. Contacts that reported weaker demand cited a decrease in merger and acquisition financing needs and the availability of alternative funding sources as the most important reasons for the change. The responses about inquiries for future C&I loans varied from slightly increased to moderately decreased. Given the historically low interest rates and the subsequent downward pressure on banks' net interest margins, this survey introduced questions about measures banks have taken to combat this situation. Contacts reported that in the past six months they have increased the use of fees and interest rate floors on C&I loans. Credit standards and demand for commercial real estate,

residential mortgage, and consumer loans remained generally unchanged over the past three months.

### **Agriculture and Natural Resources**

District crops are generally in good condition, but corn and soybean development is lagging because of the lack of rain. On average, these two crops are rated over 65 percent in good-to-excellent condition. Illinois and Indiana are considerably behind their five-year averages in corn development. For all states except Arkansas and Mississippi, setting pods in soybeans lags more than 20 percent behind their average pace. Sorghum development is ahead of schedule in Arkansas and Mississippi, whereas in Illinois and Missouri it is substantially behind average (and less than 40 percent is rated in good-to-excellent condition). On average, approximately three-fourths of the cotton and rice, which is developing ahead of its normal pace, is in good-to-excellent condition.

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### **Ninth District--Minneapolis**

Overall Ninth District economic activity increased in July and August. The residential real estate, consumer spending, manufacturing, energy and mining sectors grew, and tourism was mixed. Meanwhile, commercial building was sluggish, and agriculture was down slightly. Labor markets were soft. Wage and price increases were generally modest; however, significant price increases were noted in natural gas, long-term care insurance and tuition.

#### **Construction and Real Estate**

Overall commercial building was sluggish, but some areas of improvement were noted. During the first half of 2003, commercial construction activity in the Minneapolis-St. Paul area office and industrial markets was at its slowest level in almost 10 years, according to a real estate firm; however, leasing activity has picked up during the past two months. Another Minneapolis-St. Paul real estate company noted that July sublease space in the office market decreased by about 25 percent from year-end 2002. A number of new health care related building projects are under way or planned in northeastern Minnesota. The value of office and institutional building permits for July year-to-date in Sioux Falls, South Dakota more than doubled from a year ago.

Home building and residential real estate activity grew. By the end of July, 401 permits for new single-family homes were issued year-to-date in Billings, Montana compared with 318 for the same period a year ago, according to a city official. In the Minneapolis-St. Paul area, the number of housing units authorized was 6 percent higher in July compared with last year, and the number of home sale closures was up 10 percent.

#### **Consumer Spending and Tourism**

Overall retail sales grew moderately. A major Minneapolis-based department store and discount retailer reported same-store sales in July up 3.1 percent compared with a year ago.

A Montana mall manager noted that July sales were up 4 percent from last year. While July traffic was flat compared with last year at a Minnesota mall, August traffic was up. In North Dakota a mall manager noted flat sales in July, but an increase in August with back-to-school shopping sales, particularly in apparel. Another Minneapolis area mall reported recent sales as flat, but traffic was up 10 percent compared with a year ago. A consumer sentiment survey conducted by the Montana Bureau of Business and Economic Research

showed that Montana consumers felt essentially the same about economic prospects in July as they did in December 2002.

Tourism activity was mixed. In South Dakota, a tourism official noted that visits to a Black Hills ranger station were up between 20 percent to 75 percent on any given day compared with last year. Visits to Mount Rushmore were up 2 percent in July over a year ago. Tourism activity was steady to up a little bit over last summer in North Dakota, an official said. An outfitter in northern Minnesota reported activity level with a year ago. However, in the Upper Peninsula of Michigan, July expenditure at tourism-related businesses was off about 10 percent compared with a year ago. July visits at Glacier National Park were down about 30 percent due to forest fires.

### **Manufacturing**

Manufacturing activity was up slightly. Preliminary results from an August survey of district manufacturers by the Federal Reserve Bank of Minneapolis and the Minnesota Department of Employment and Economic Development revealed that businesses expect new orders and production to increase in the second half of 2003 from the first half. In addition, a July survey of purchasing managers by Creighton University (Omaha, Nebraska) indicated overall increased manufacturing activity in the Dakotas and Minnesota. As evidence, a human vaccine producer plans to expand in South Dakota, and a North Dakota brick manufacturer recently completed a plant upgrade to double production. A shower and bath spa company in the Upper Peninsula recently added a production facility and additional shifts to keep up with demand. However, a North Dakota cheese processing plant and a pasta factory shut down, and a consumer housewares producer plans to close a manufacturing facility in Minnesota.

### **Energy and Mining**

Activity in the energy and mining sectors increased slightly. Early August district oil and natural gas exploration levels increased slightly from early July. In addition, a power plant, a gasoline refinery, and wind and ethanol facilities are in development or design in the district. Meanwhile, most major district iron ore mines are operating at near capacity, although cost cutting and productivity enhancements were announced at several mines. A Montana copper mine plans to reopen this fall.

### **Agriculture**

Agricultural economic activity was down slightly. Significant soybean aphid infestations were reported in parts of Minnesota. Lack of moisture caused stress to district row crops and livestock as drought conditions expanded across most of the district. Row crop farmers across the district complained of reduced yield expectations due to lack of rainfall. The U.S. Department of Agriculture rated 62 percent and 37 percent of pastureland in Montana and South Dakota, respectively, as poor or very poor. However, preliminary results of the Minneapolis Fed's June Survey of Agricultural Credit Conditions revealed that 35 percent of lenders expect above average farm income during the third quarter. The mid-summer dry weather assisted small grain harvests. The USDA rated about three-quarters of the Minnesota and North Dakota spring wheat and barley crops as in good or excellent condition.

### **Employment, Wages, and Prices**

Labor markets were soft. Employment levels were down almost 1 percent among district states in July compared with a year ago. Minnesota's initial claims for unemployment

insurance increased 4 percent in July compared with last year. Layoff announcements included the closure of two call centers in South Dakota that resulted in 230 job cuts. In Minnesota a circuit board manufacturer cut 100 jobs and a maker of power-conversion products eliminated 40 jobs. A mine in the Upper Peninsula reduced employment by 50 positions. A retailer in the Minneapolis area recently received 1,600 applications for 150 positions at a new store. Preliminary results of the survey of district manufacturers show that respondents expect only slight employment growth for the rest of 2003.

In contrast, home building contractors recently noted difficulty finding available laborers in Billings, Montana. In St. Paul, a temporary services firm noted that demand was relatively strong this summer compared with last year. Recently revealed expansion plans include a Minnesota online education firm that may increase employment by about 400 positions. A new call center in North Dakota plans to employ up to 125 employees. Overall increases in wages were moderate. For example, union members at two Minnesota newspapers agreed to annual wage increases of about 2 percent to 3 percent over the next four years. However, the average wage for hired workers on farms in Minnesota, Michigan and Wisconsin increased 12 percent in July compared with a year ago.

Price increases were generally modest, with exceptions noted in prices for natural gas, long-term care insurance rates and tuition. District manufacturers expect product prices to remain level for the rest of 2003, according to preliminary results of the manufacturing survey. Several thousand households in Montana recently saw natural gas rates jump 35 percent over a year ago. Some insurance companies in Minnesota just announced premium increases for long-term care insurance of 20 percent to 45 percent compared with last year. Tuition increased about 12 percent to 15 percent at the University of Minnesota for 2003-2004 compared with last year.

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## **Tenth District--Kansas City**

The Tenth District economy continued to improve in late July and early August, and business contacts were generally upbeat about future activity. The manufacturing sector added to gains made earlier in the summer, retail sales again rose slightly, and housing and energy markets remained strong. On the negative side, commercial real estate activity weakened slightly after showing signs of stabilizing in recent months. In the farm economy, hot, dry weather harmed crop and pasture conditions. Wage and price increases remained minimal, while employee benefit costs continued to rise.

### **Consumer Spending**

Retail sales in the district increased slightly in late July and early August and were above year-ago levels at most stores. Retailers attributed part of the improvement to consumers spending federal tax rebate checks. Among product categories, sales of men's and children's apparel, particularly back-to-school clothes, were strongest. Some softness was evident, however, in sales at high-end stores and in sales of jewelry. Most retailers expect sales to increase further through the fall. Store managers were generally satisfied with inventory levels and plan only seasonal changes in coming months. Sales of new motor vehicles in the district increased slightly in late July and early August, and, in a change from the previous survey, sales of used vehicles also rose. Auto sales, however, were still somewhat lower in most areas than last year's high levels. The improvement in vehicle sales in recent months



has allowed most dealers to reduce or eliminate excess inventories heading into the new model year. Nearly all dealers remain optimistic about future sales, due in part to the anticipated continuation of manufacturer incentives. Travel and tourism activity was mixed across the district. Airport traffic increased from earlier in the summer in several cities but was down somewhat in others. Rafting activity in Colorado was reported to be solid, and hotel occupancy rates in Denver finally rose back above year-ago levels. On the other hand, some recreation businesses in and around Yellowstone reported fewer visitors in early August due to wildfires.

### **Manufacturing**

District manufacturing activity expanded further in late July and early August, and most managers were optimistic about future output. Plants reported slightly higher levels of capacity utilization than in the previous survey, and the volume of new orders rose considerably. Producers of pharmaceutical goods reported the strongest activity, while some makers of fabricated metal products continued to struggle. Several manufacturers reported that recent increases in demand have spurred longer workweeks and some new hiring. However, factory production remained slightly below year-ago levels, and capital expenditures were still sluggish at most firms. In addition, several firms indicated concern about the continuing impact of high energy and insurance costs on their profit margins.

### **Real Estate and Construction**

Residential real estate activity in the district remained strong in late July and early August, while commercial real estate activity weakened slightly. Single-family housing starts maintained a rapid pace in most district cities, with starts of entry-level homes particularly robust. Builders reported that demand for virtually all types of homes was boosted somewhat in recent weeks by home-buyers rushing to sign contracts for new houses before mortgage rates rose further. Builders generally expect strong single-family construction to continue through the fall. Home sales also remained brisk across the district in late July and early August, and inventories of unsold homes showed signs of stabilizing in most markets after rising earlier in the year. Like builders, realtors in some cities reported increased buyer traffic in July after mortgage rates began to rise. Most realtors expect sales to hold steady in coming months. The strong residential real estate activity boosted demand for home purchase mortgages, partly offsetting a steep decline in refinancings. Mortgage lenders generally expect the shift from refinancings to home purchase loans to continue, with overall loan demand moving lower through the fall. Most commercial real estate markets in the district weakened slightly in late July and early August after showing signs of stabilizing in previous surveys. Sales and absorption of office space eased in most cities, while vacancy rates edged higher. Looking forward, realtors expect commercial real estate activity to remain sluggish for at least the remainder of the year, but they generally do not anticipate further deterioration in conditions.

### **Banking**

Bankers report that loans increased and deposits held steady since the last survey, boosting loan-deposit ratios somewhat. Demand for home purchase mortgages continued to rise, and demand for commercial real estate loans increased as well. In contrast, demand for business loans and consumer loans was largely unchanged. On the deposit side, slight increases in demand deposits and NOW accounts were offset by a decline in large CDs. Most respondent banks held their prime lending rates and consumer lending rates steady, and lending standards were unchanged.

## **Energy**

District energy activity continued at a solid pace in late July and early August. The count of active oil and gas drilling rigs in the region edged higher. Moreover, district bankers reported strong loan demand for gas field equipment and development, suggesting that natural gas production will continue to increase. After easing slightly in late June and July, natural gas prices began to rise with higher temperatures in August and are expected to remain elevated in coming months. Some contacts fear a spike in prices this winter if hot summer temperatures prevent gas supplies from being adequately replenished by November, or if winter temperatures turn out to be colder than normal.

## **Agriculture**

Hot, dry weather had a marked adverse impact on the district's farm economy in late July and early August. The condition of corn and soybean crops deteriorated, and planting prospects for winter wheat were poor. Pasture conditions throughout the district also showed signs of deterioration. While herd liquidations did not increase, most livestock producers were not expanding their herds. Strong cattle prices will boost profits for livestock producers this year, but district bankers do not expect borrowers to recover all of the losses incurred over the last few years. District farmland values continued to be boosted by nonfarm demand in scenic areas and for recreational use.

## **Wages and Prices**

Wages and prices remained relatively stable in late July and early August. Labor markets were still quite slack around the district, and managers reported worker shortages in only a few occupations, including pharmacists and security guards. The pace of layoff announcements picked up slightly but remained much slower than earlier in the year. Firms generally do not expect further reductions in their workforces, but the vast majority of firms also plan very little hiring until 2004, due in part to productivity enhancements. Wage pressures were virtually nonexistent, with nearly all firms offering only cost-of-living increases or less. Benefit costs continued to rise, however, and most firms do not expect health insurance inflation to subside anytime soon. Overall, pricing trends have remained largely unchanged from the previous survey. Retail prices remained flat, and building contractors and manufacturers reported little ability to raise their prices in the face of rising fuel and energy costs. Retailers expect little change in prices in coming months. However, manufacturers anticipate some increases in steel prices heading forward, and builders expect slight increases in some construction material prices, including gypsum wallboard.

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## **Eleventh District--Dallas**

Eleventh District economic activity remained generally weak from mid-July to late-August but there is improved optimism about the outlook for activity. There was little change in manufacturing or service sector activity, but retail sales were higher. Contacts at financial institutions reported slightly improved conditions. Construction and real estate markets were also very slightly improved. There was little change in energy activity, and dry weather hampered agricultural production.

## **Prices**

Higher energy costs were reported as a concern, particularly by manufacturers, and these

increased costs are being passed along to consumers when possible. Crude oil prices moved in a narrow range of \$30-\$32 for West Texas Intermediate during the period. U.S. crude inventories are only slightly higher than the 27-year low set during the disruption of Venezuelan crude deliveries earlier this year. Retail gasoline prices nationally rose from \$1.53 to \$1.58 between late June and early August. The blackout is expected to briefly add another 10 cents to gasoline prices. Gasoline inventories remained at the lowest levels of the last 8 months.

Natural gas prices fell steadily throughout the period as storage continued to fill at a faster than normal pace, but prices remain high compared to this time last year. Spot prices fell to \$4.60 in late July, a decline of 60 percent since February. Natural gas in storage is now only 9.4 percent below the 5-year average, and 18 percent below last year. Storage was 35 percent below the five-year average earlier this year. Natural gas going into storage this summer does not appear to be coming from new supplies, rather it is the result of "demand destruction"-large industrial users closing, cutting back or switching to oil.

Prices continue to fall for most manufactured products, including apparel, lumber and paper. Paper producers say that consolidation in the industry is keeping prices 10 percent to 15 percent higher than demand would dictate, and future price declines are anticipated. Prices for fabricated metals are being heavily discounted (or the quality of the product improved) to keep up with the competitiveness of the industry, despite rising input prices.

### **Manufacturing**

Manufacturers continued to report tough economic conditions, with lower than expected demand and continued layoffs at some plants. Still there were some reports of increased activity and many contacts were more optimistic-or less pessimistic-than they were six weeks ago. The pace of layoffs appears to be slowing.

Paper producers say that demand remains soft even though this should be a time of seasonally increasing activity. Contacts attribute the weakness to a lack of manufacturing activity, and say that the pick up in demand for boxes to ship Christmas orders was smaller than is typical. Some paper companies have reduced their workforce to cut costs, eliminating support positions rather than production workers. Others firms anticipate some future layoffs if business does not pick up.

Construction-related manufacturers reported a slight increase in demand but expressed concern that, without a backlog of orders, the outlook for activity is uncertain. Demand for fabricated metals and lumber picked up. The increase in lumber sales was partially seasonal, and contacts say that sales are just "less horrible" than they have been in the past. Demand for brick and cement was unchanged, but competitive pressures remain stiff. Companies say they are still finishing up projects stimulated by lower interest rates, and indicated some worries that rising mortgage rates could dampen demand down the road.

Demand for primary metals has been "spotty" over the past month. Contacts say the industry is experiencing stronger demand than a year ago and quoting activity has increased. Demand for apparel products is picking up, but manufacturers continue to lay off workers to remain competitive. There was little change in demand for food products.

Orders of high-tech products continued to increase, although at a slower pace than the strong second quarter. Steady gains in personal computer and cell phone sales since the last survey continued to drive the demand for semiconductors. Asia was reported to be a hotbed

for semiconductor production and consumption while demand in the U.S. was described as "better but not robust." Much of the demand for PCs continues to come from consumers, but replacement demand by businesses continues to improve. One respondent noted that there is still little hiring because companies are improving profits by driving up productivity as far as they can. Most respondents expect continued improvement for the remainder of the year.

Demand for chemicals remains weak and prices have fallen again for ethylene, propylene, styrene, polyethylene, polypropylene, and polyvinyl chloride. Demand has been sluggish domestically, and export markets are hurt by the high price of natural gas relative to oil.

A series of accidents and unplanned outages at refineries caused several spikes in the price of gasoline in July, and tightened supply enough to move spot prices over \$1.10 per gallon in late August. Additional refinery outages as a result of the blackout further reduced production and impaired pipelines. Gasoline consumption for the first half of 2003 was down compared to a year ago, the first six-month decline since the 1990-91 recession. Capacity utilization on the Texas and Louisiana Gulf Coast rose slightly from 95 to 96 percent. Refiner's margins improved throughout the period, mainly on the basis of higher gasoline prices.

### **Services**

There was increased optimism in the service sector, although activity was mostly unchanged. Demand is mostly unchanged for temporary staffing and placement, although there was a pick up in staffing needs for tech support and call centers. Legal contacts also reported little change in overall activity. There has been some drop-off in regulatory work, but activity is steady for litigation and bankruptcy. There is still little demand for mergers and acquisitions, and this comes as somewhat of a surprise as contacts anticipated a reaction to pent-up demand by now. Legal work to support transactions has picked up a little and clients are beginning to plan more for the future.

With the exception of higher than expected fuel prices, airlines continue to report steady improvement. Overall, airplanes are carrying more passengers and prices are moving up. As long as industry capacity stays where it is, the outlook has improved in the medium term. The outlook for trucking is "looking a little better." Rail shipments in the Western U.S. are still running slightly higher than year-ago levels. Future months could see some upward pressure on prices if rail capacity is tested with rising demand.

### **Retail Sales**

Retail sales growth increased over the past six weeks, and retailers are cautiously optimistic that sales will continue to meet the high end of expectations. While there was some question about how much the sales pickup was stimulated by tax refund checks, retailers who cashed checks in the stores believe the increased sales are not entirely induced by tax credits. Competition remains stiff, and retailers say they still have no pricing power. Because prices have fallen for most products, contacts note that the volume of sales has increased by more than the dollar growth of sales suggests. There has been no change in the pace of automobile sales. Respondents expect steady business ahead, but not to the peak-levels experienced in the last couple years.

### **Financial Services**

Financial conditions have improved slightly leading contacts to be more optimistic about the outlook for activity, although caution remains. Business is returning, according to

respondents, who say that traffic and referrals are up, and customers appear to be expressing more interest in capital investment and doing deals, but are not yet ready to pull the trigger. Deposit growth remains strong and loan demand appears to be stable to up in most categories. Mortgage activity is still the strongest category with consumer lending close behind. The recent increase in mortgage rates has spurred people to act before rates increase further, according to contacts. Auto lending remains weak with strong competition between banks, credit unions and "captive" lenders, such as GMAC or Ford Credit. Commercial and industrial lending is mildly positive but caution is still prevalent.

### **Construction and Real Estate**

Construction and real estate markets improved some over the past six weeks. Contacts say the up-tick in mortgage rates pushed some fence-sitters into the new and existing-home markets. The industry remains very competitive, restraining price increases. New home construction rose in some metro areas, but contacts believe building will ease in the latter part of the year. The strong housing market has come at the expense of the apartment market, which continues to experience growing supply and reduced demand.

Contacts are more optimistic about commercial real estate markets. A recent pick up in leasing inquiries seems to have ended the deterioration in the office market. With little office construction underway, contacts are hoping for improvement later in the year, although it is unlikely that a noticeable turnaround will occur until 2004. Retail markets remain the best performing of the commercial sectors. Demand for industrial space was up in Houston and flat to down in Dallas.

### **Energy**

After growing strongly in the early part of the year, District drilling activity leveled off in mid-May and has remained relatively constant. Drilling in the Gulf of Mexico remains unchanged, although some rigs moving to Mexico may improve utilization and day rates. The U.S. domestic rig count leveled off in recent weeks before dropping sharply at the latest weekly reading. The decline raised concerns that domestic activity is peaking, but the drop was related more to wet weather than to market fundamentals. International drilling remains strong. Respondents continue to describe the current market as very good if not great, and to be moderately optimistic about the future. Pricing is adequate for capital recovery, but companies are controlling costs and remain cautious about hiring. Despite slower growth in domestic activity, service companies continue to report a good market, with adequate margins and pricing that continues to slowly improve.

### **Agriculture**

Hot, dry conditions reduced soil moisture and stressed some crops. The cotton crop, especially dryland cotton, has suffered damage because of the heat, and yields are expected to be below year-earlier levels. Hot weather has also affected the corn crop. Crop production continues to be hampered by high energy costs and relatively low commodity prices. The cattle market remains in relatively good shape with steady demand and stable prices, but some contacts said water supplies were getting low, and range conditions were deteriorating quickly in the heat. Supplemental feeding of cattle continues in the driest areas.

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## **Twelfth District--San Francisco**

Reports from Twelfth District contacts indicated a modest increase in overall economic activity in late July and August, representing an improvement in the pace of growth. With the notable exceptions of health care services and energy, contacts noted little upward pressure on prices and wages. Retailers reported that sales were generally up and that discounting was less pervasive than in past survey periods. The District's software services, travel, and tourism sectors saw improvements. Reports indicated that manufacturing activity continued to rise; orders strengthened for manufacturers of semiconductors, machine tools, and basic metals. Conditions for District agricultural and resource-related businesses remained solid. Respondents indicated that demand for homes continued to be strong, while commercial real estate generally remained in the doldrums. Banking contacts reported some slight improvements in commercial loan originations, particularly among small businesses, and a sharp decline in mortgage refinancing in response to the rise in long-term interest rates.

### **Prices and Wages**

District respondents reported that prices for final goods and services exhibited very little upward movement in the most recent survey period. Exceptions to this pattern were for health care services, natural gas, and gasoline. Contacts noted ample labor supply and little upward pressure on wages in most areas. In contrast to wages, several employers noted that they continued to face pressure from increases in non-wage labor costs such as health insurance benefits and workers' compensation and liability insurance, particularly in California.

### **Retail Trade and Services**

Reports from District retailers indicated improved sales during the most recent survey period. Contacts reported solid automobile sales (spurred in part by generous incentives), especially for foreign brands. Favorable financing terms and strong home sales helped prompt sales of large appliances. Discounting among retailers reportedly was less pervasive than in previous survey periods. In response to stronger sales, a big-box retailer finally acted on its expansion plans and proceeded with the construction of additional stores in the Pacific Northwest.

Demand for several other District services strengthened a bit. Of note, contacts indicated that demand for both air and water transportation services trended up. Additionally, new orders for some software and media services increased slightly, with the exception of enterprise software where business is still very slow. District service providers reported a slight increase in demand for both part-time and full-time employees in IT services. On the downside, telecommunications service providers continued to be plagued by soft sales and excess capacity. About an equal number of District retailers and service providers planned to either increase or leave capital spending unchanged, while only a small number expect capital spending to decrease in the near term.

Reports indicated that conditions in the District's travel and tourism sectors improved slightly in late July and August. In Hawaii, increases in domestic visitor counts largely offset declines by international visitors. Hotel occupancy rates inched up in Hawaii, California, and other areas. However, the restaurant industry continued to face below-normal demand in some markets.

### **Manufacturing**

Overall District manufacturing activity picked up in late July and August. Demand for semiconductors improved and capacity utilization, particularly for leading-edge products, reportedly remained high. Respondents noted that semiconductor prices increased slightly, although competition held down prices for most IT products. Producers of other manufactured products, such as machine tools and basic metals, also reported improved orders. Consistent with improved conditions, a majority of manufacturing respondents indicated plans to increase total capital spending and spending on IT in the next several months.

### **Agriculture and Resource-related Industries**

Agricultural contacts noted continued strength in export activity. Respondents reported stable prices overall for crops and livestock. Demand for natural gas was boosted by hot weather in late July and August. Also, poor water conditions are expected to reduce the amount of hydro-power and increase the demand for natural gas. In response, natural gas prices rose in recent weeks, and rig counts and extraction have been increasing. Gasoline prices in the district also increased as a result of a break in an Arizona pipeline.

### **Real Estate and Construction**

Housing demand remained a bright spot in the District's economy. New home construction continued at a brisk pace across the District, particularly in areas where demand exceeded supplies, namely Hawaii and Southern California. Several respondents believed that housing demand increased as some home buyers rushed into the market fearing that interest rates may escalate further.

On the commercial side, high vacancy rates continued to characterize many District markets, including the San Francisco Bay Area and Las Vegas. Contacts reported very little commercial construction activity outside of Hawaii and Southern California.

### **Financial Institutions**

Throughout the District, increased interest rates have sharply reduced mortgage refinancing activity, although originations for new mortgages remained strong. Contacts reported some signs of improvement in the demand for commercial loans, particularly among small businesses. Respondents noted that some of the pickup in commercial loan demand likely owes to anxiety over possible future increases in interest rates. Finally, a majority of District banks reported plans to increase total capital spending as well as spending on IT in the next several months.

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