



June 15, 2005

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

### Summary

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Prepared at the Federal Reserve Bank of Atlanta and based on information collected before June 6, 2005. This document summarizes comments received from businesses 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 all twelve Federal Reserve Districts indicate that business activity continued to expand from mid-April through May. Most Districts--including New York, Richmond, Atlanta, Chicago, Minnesota, Kansas City, and San Francisco--characterized the pace of expansion as moderate, solid, or well-sustained. However, Philadelphia noted that the pace of growth had eased in May while Boston and Cleveland observed some unevenness across sectors.

Retail activity was mixed. Several Districts reported disappointing May retail sales results and cited unseasonable weather as the principal reason. A few reports mentioned that high gasoline prices were having a negative impact on sales. Almost all reports on other service industries were quite positive. Residential real estate markets remained strong in most Districts, and several Districts reported improving commercial real estate conditions. Most Districts reported that manufacturing activity continued to expand overall, although some reports described varying conditions across industries.

Labor markets improved in most Districts. Overall price pressures were moderate, but several reports noted concern over high fuel, transportation, and building materials costs.

### Consumer Spending

Reports on retail sales in April and May were mixed. Richmond reported that May sales and store traffic picked up markedly, and Kansas City noted that consumer spending expanded solidly in April and May. St. Louis, Minneapolis, Dallas, and San Francisco also reported gains in consumer spending. Sales were characterized as mixed by merchants in Atlanta and Cleveland and as having edged down in the Philadelphia District. Chicago retailers described sales as subdued, and those in New York reported sales as soft. Boston, New York, Cleveland, Philadelphia, Atlanta, Chicago, and Minneapolis noted that unseasonable weather had dampened sales in May. In addition, Cleveland, Philadelphia, Kansas City, and Dallas said that high gasoline prices had a negative impact on retail sales.

Automobile sales were reported as mixed by Atlanta, Kansas City, Chicago, and Dallas,

sluggish in Cleveland, and down in the Philadelphia, Minneapolis, and St. Louis Districts. Meanwhile vehicle inventories were above desired levels according to Chicago, Philadelphia, and Dallas. Dealers in the Philadelphia area boosted leasing promotions to lower some excess inventories. Atlanta and San Francisco noted that high gasoline prices were having a negative impact on sales of SUVs and light trucks.

### **Services and Tourism**

According to most reports, industries in the service sector continued to display solid growth in April and May. Dallas reported that the transportation industry continued to experience strong demand conditions, but also noted concerns about high fuel costs. San Francisco reported that demand for media and high-tech services strengthened and that activity among transportation, food, and healthcare service providers remained vigorous.

Reports from the tourism and hospitality industry remained positive. Tourism remained exceptionally strong in New York City. Manhattan's hotel occupancy rate was more than 2 percentage points higher in April than a year ago and average room rates were up 17 percent. Richmond said that hotel bookings at coastal hotels for the Memorial Day weekend were somewhat stronger than a year earlier and that rapidly rising demand for hotel rooms in the nation's capital drove room rates sharply higher in recent months. Atlanta also noted that hotel and resort occupancies were at high levels. St. Louis reported strong sales and employment gains in the hospitality services industry, and San Francisco reported that the travel and tourism sector continued to surge. Spring tourism was flat because of cool weather according to Minneapolis, but tourism officials remained optimistic about the summer season.

### **Construction and Real Estate**

Reports on residential real estate markets remained quite positive overall, although some slowing in activity was noted in a few markets. Philadelphia and Atlanta reported that home sales were brisk and strong, respectively. St. Louis reported that home sales continued to rise, while Kansas City and Chicago stated that activity remained solid. San Francisco reported that home sales continued to be rapid, although growth slowed somewhat relative to previous periods. Richmond and New York said that housing markets remained strong, but both noted some easing in demand in high-end markets. Minneapolis described real estate markets as mixed. New home sales weakened slightly, according to Cleveland, and Dallas noted that in some parts of the District the supply of new homes had outstripped demand. St. Louis and Minneapolis cited permit data that indicated some moderation in construction is likely.

Several Districts reported improvements in commercial real estate markets. New York and Dallas saw signs of strengthening activity, with office vacancy rates retreating in several local markets. Leasing activity has been fairly strong, according to Philadelphia, and Richmond noted that rents firmed and new construction has increased. Atlanta saw solid improvements as firms moved forward with expansion plans; development also increased at a steady pace in Cleveland and Chicago and continued to improve in San Francisco. Modest improvements were noted by Kansas City and Minneapolis. However, St. Louis reported that commercial markets were mixed, and Boston noted that local markets continued to struggle.

### **Manufacturing**

Most Districts reported that manufacturing activity continued to expand, although several Districts noted that production had slowed or leveled off. Atlanta and San Francisco reported that defense contracts had generated new orders for local manufacturers, while Boston and

San Francisco cited strong demand for aircraft-related and computing equipment. Durable goods production was improving, according to Minneapolis and Cleveland, although Cleveland noted that steel production was softer. Boston and Dallas described manufacturing activity as mixed overall, and the pace of expansion, although positive, had reportedly slowed in some industries, according to San Francisco, Chicago, and Philadelphia. St. Louis, Boston, Minneapolis, and Chicago cited varying degrees of weakness in vehicle production, although Cleveland reported year-over-year gains in auto production in the two-month period ending in May. Several reports noted that manufacturing firms are planning to increase capital spending, open or expand plants, and increase operations to meet expected demand. The majority of Districts reported manufacturer concerns regarding higher input prices, especially in energy-related goods.

### **Banking and Finance**

For most Districts reporting on financial services, the demand for loans either increased or remained solid. Most Districts cited increases in commercial lending activity, although Richmond noted a slower pace in some areas. Philadelphia linked new commercial borrowing to rising capital expenditures by firms in a wide range of industries. Atlanta and Chicago reported stronger consumer loan demand, but St. Louis and New York reported some slowdown, and Cleveland described activity as mixed. Residential real estate lending was described as rising or remaining solid in most Districts. Dallas reported some concern about a potential glut in multi-family residential properties. Other banking indicators were holding steady or improving, and credit quality was described as good.

### **Labor Markets and Prices**

Labor market conditions continued to improve in most Districts, and several reports cited difficulty finding specific types of workers. For instance, Dallas reported a shortage of skilled workers in the energy industry, while Atlanta and San Francisco noted similar shortages in construction. Cleveland reported that manufacturing firms had difficulty obtaining qualified applicants for job openings. San Francisco described tighter supply conditions in nursing and financial service professions. The demand for temporary workers strengthened in the Richmond, New York, and Atlanta Districts, while Chicago noted a small decline from a year earlier. San Francisco and Dallas reported rising wages, mainly in professional services, while Minneapolis noted only modest increases in wages.

Reports from most Districts indicated that price increases at the retail level remained modest overall. San Francisco noted that price inflation for final goods and services edged up, largely because of the pass-through of earlier increases in energy costs. Several Districts noted increases in transportation and healthcare costs. Prices were up for construction-related materials, such as lumber, cement, brick, tile, and glass in many Districts. Some Districts noted that manufacturers were unable to pass along rising costs of raw materials because of the presence of long-term contracts and competitive pressures from foreign producers. However, Cleveland reported that firms have had some success in passing input cost increases along to their customers.

### **Agriculture and Natural Resources**

Despite less-than-ideal weather, crop conditions were described as between fair and good for most reporting Districts. Cold weather slowed plantings and crop development, according to Richmond and Kansas City. Also, heavy rains in California's central Valley region damaged some fruit crops. Dallas and San Francisco noted concerns over higher costs of fuel and fertilizers.

Activity in the energy industry has remained strong especially for oil field services. Dallas reported strong drilling activity, long backlogs, and a dearth of skilled workers. San Francisco and Minneapolis reported that producers were operating at or near full capacity. Kansas City noted that drilling firms expected moderate expansion of drilling activity in the months ahead.

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## **First District--Boston**

Business contacts report continued growth in the New England economy, although some sectors are lagging the overall pace. Retailers cite healthy increases in sales, while manufacturers and software and information technology (IT) services firms indicate that results range from "okay" to robust. Staffing firms also report increasing demand, but some say the pace is slower than last quarter. While comments about rising prices are less at the forefront than in the last report, high input costs remain a concern. Commercial real estate markets in the region remain sluggish.

### **Retail**

All First District retail contacts report strong increases in April same-store sales from a year earlier, ranging from 4 to 9 percent. However, most indicate dismal New England weather damped May's results. Sales of lumber and hardware remain particularly strong as the housing boom continues. Flat-screen televisions, digital cameras, wireless networking and other higher-end goods are said to be selling well. By contrast, top-of-the-line clothes are not.

Inventory levels are up slightly according to most contacts, but are in line with sales. Multiple respondents report rising vendor prices for petroleum and steel-related products; lumber and television prices are falling and appliance prices are increasing. Most vendor price changes are being passed on to consumers, although selling prices for clothing have continued to fall due to competitive pressures. Gross margins are slightly up for most contacts. Wage growth and employment are mostly stable, although some retail contacts report increased headcount due to acquisitions, new stores, or increased sales. Most contacts are increasing capital spending in order to upgrade distribution methods or outdated information technology equipment, and they have the cash on hand to do so. Those who aren't currently upgrading their equipment did so recently.

Retail respondents are now more optimistic about their business than they were last quarter, and they all expect sales in coming months to be as strong as their April numbers, if the weather is decent. The one serious source of concern for several contacts is rising health insurance costs.

### **Manufacturing and Related Services**

First District contacts in manufacturing and related services report mixed sales and orders through the second quarter of 2005. Demand for aircraft-related and computing equipment is said to be strong and rising. Sales of some other capital goods and semiconductor sales are reportedly improving as well. However, many manufacturers describe business as merely "okay," if not "disappointing." A couple of firms cite transitory factors such as poor spring weather or the early Easter. Others note weakening demand for cargo containers or transportation services, or softening demand from the Big Three automakers. A common refrain from contacts is that their firm "has the volume, but not the margins"--which they

tend to attribute to either low-cost competition from Asia or high input prices.

On the whole, manufacturers remain quite concerned about the high costs of raw materials, energy, and transport. Various respondents indicate that although they no longer face escalating costs for metals or petroleum products, they need to increase their selling prices further to restore margins to acceptable levels. Manufacturing contacts express doubts that large retail chains and other business customers would accept price increases, or that their competitors would follow suit. Only those firms producing unique or technologically advanced products seem largely unconcerned about margin pressures.

Companies continue to explore outsourcing and other methods to reduce production-worker and back-office employment. Pay for these types of jobs is said to be rising at a rate of 2.5 percent to 3 percent. Markets for professional, technical, and managerial employees are said to have tightened, resulting in salary increases of 3.5 percent to 4 percent and some delays in filling positions.

Manufacturers tend to be holding their capital spending constant or increasing it slightly. They are investing in new capacity overseas while concentrating mostly on improving efficiency and automation or developing new products at domestic facilities.

Respondents are mostly guardedly optimistic about their business through the end of 2005, although several note the adverse effects of high input costs on their profitability. Compared to past conversations, manufacturers express greater concern or uncertainty about longer-term strategies.

### **Temporary Employment Firms**

Demand for temporaries continues to grow, but some companies report that the rate of growth seems to be slowing. This pause seems most pronounced for manufacturing and light industrial positions. By contrast, demand is said to be strong for technical and IT-related workers, as well as for engineering, financial, healthcare, administrative, and government-related employment. Permanent hiring continues to grow at a strong pace, and the available supply of labor continues to decrease, albeit gradually.

Prices are steady or rising slightly. Unemployment insurance costs are increasingly worrisome, and health insurance continues to be a concern. Worker's compensation insurance costs are flat or slightly down in the past few months. While more hesitant to give concrete predictions of future performance than they were three months ago, staffing respondents are fairly confident about the recovery, and believe 2005 will be a better year than 2004.

### **Commercial Real Estate**

Commercial real estate markets in New England continue to struggle. Despite some increase in employment, most office markets in the region have not experienced any substantial improvement during the past quarter. Large firms have not hired enough people to make a difference in overall demand for space. In addition, consolidations and acquisitions by out-of-state companies have increased vacancy rates in some areas. In the Boston market, office vacancy rates remain in the mid-teens in the city and exceed 20 percent in the suburbs. Contacts do not expect office rental market conditions to improve noticeably until the region's job growth picks up its pace.

At the same time, office buildings in Boston continue to sell at what contacts call "exorbitant" prices. One respondent expressed concern that high building prices raise the

probability of new construction of office buildings, which would further raise vacancy rates.

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

Contacts in the software and IT services industries report year-over-year quarterly revenue increases ranging from near zero to 13 percent in their most recent quarters, with half the contacts close to the high end of the range. A couple of respondents mentioned particularly strong demand growth from customers in the financial services industry.

Over half of contacted firms are increasing their headcounts, generally modestly, via selective hiring of technology workers and marketing/sales personnel. One software firm is focusing its additional hiring in India; another is recruiting aggressively in Massachusetts. Most respondents report that wage increases are moderate, notwithstanding some perceived tightening in technology labor markets.

Software and IT services contacts indicate they are holding capital spending fairly level. One respondent explained that they are increasing the number of computers and servers in proportion to increases in personnel, but declining computer prices allow them to do so without raising spending.

The outlook among software and IT services contacts is cautiously positive, with most expecting a continuation of their current pace of growth. The economy is viewed as somewhat uncertain; it is said to be currently steady--not robust, not deteriorating--but with more downside than upside risks.

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

The Second District's economy has continued to expand at a well-sustained pace since the last report, despite some weather-related softness in consumer spending. While there are some signs of increased cost pressures, retail prices have remained stable. Manufacturers generally report that business has picked up again in recent weeks, after a lull in April and early May; they also indicate some acceleration in input prices. Retailers indicate that sales were generally below plan in May, but hotels and other tourist-related businesses again report brisk business and sturdy revenue growth.

Residential real estate markets showed continued strength in May, though there were scattered signs of softening at the high end of the market. Office markets have gained momentum in April and May, particularly in Midtown Manhattan and northern New Jersey, while industrial markets have strengthened modestly. New York City's financial industry reports some slowing in business activity in April and May. Finally, bankers report a pickup in demand for home mortgage loans but some softening in consumer loan demand, as well as some tightening in credit standards and lower delinquency rates in that segment.

### **Consumer Spending**

Retailers report that sales were below plan in May, as cool weather hampered sales of seasonal merchandise, such as summer clothing, swimwear, and lawn and garden supplies. Sales of home goods were also weak. However, sales of cosmetics, jewelry and accessories were characterized as strong. Overall, on a year-over-year basis, same-store sales were little changed, with reports ranging from a 6 percent decline to a 3 percent increase. Inventories were said to be in good shape, with excess warm-weather merchandise expected to sell well

in June. Retailers indicate that both selling prices and merchandise costs are stable to up slightly.

Tourism remained exceptionally strong in April and May, especially in New York City. Manhattan's hotel occupancy rate was more than 2 percentage points higher in April than a year ago, and average room rates soared 17 percent. Indications are that a similar pattern continued into May. Broadway theaters report increasingly robust attendance and revenues since the last report; from mid-April through the end of May, attendance was up 10 percent from a year ago, while total revenues rose 15 percent--the strongest year-over-year gain since March 2004. Buffalo-area hotels also indicate that business was stronger in April than a year earlier, buoyed by strong convention business.

Consumer confidence was mixed in May. Siena College's monthly survey of New York State residents shows confidence edging up in May--confidence jumped in the New York City area but slipped to a 2-year low upstate. Based on the Conference Board's survey of Middle Atlantic region residents, consumer confidence slipped to a 6-month low in May, and the expectations component fell to a 15-year low.

### **Construction and Real Estate**

Housing markets showed continued strength in April and May, though residential construction activity has tapered off a bit. New Jersey homebuilders report that demand generally remains strong, though there are signs of softening at the high end of the market where queues of buyers are said to have shortened. Prices of new homes are estimated to be up about 8 percent over the past year, while construction activity has slowed somewhat from 2004 levels. A contact at a major builders' association expresses concern about the growing preponderance of adjustable-rate mortgages and no-equity financing.

Manhattan's co-op and condo market continued to show strength in April and May. Prices retreated following a first-quarter spike but remain well ahead of a year ago, while sales volume held steady at a high level. Moreover, the inventory of available apartments declined in May, except at the high end of the market where there has been a good deal of new development. New York City's rental market is reported to have picked up a bit: the available inventory has decreased, and rents are up roughly 5 percent over the past year.

Commercial real estate markets across the New York City metro area showed signs of strengthening in April and May. In particular, office markets in Midtown Manhattan and northern New Jersey have gained momentum, with vacancy rates falling noticeably and rents escalating. Office vacancy rates also declined modestly in Lower Manhattan and Westchester, though rents remain lower than a year ago, while markets in Long Island and southwestern Connecticut were steady. Industrial markets strengthened in Long Island, New York City, Westchester and southwestern Connecticut, and were steady in northern New Jersey.

### **Other Business Activity**

A major NYC employment agency, specializing in office jobs, reports that hiring activity quickened again, after a lull in April. This contact notes that firms are offering somewhat higher starting salaries than earlier in the year. However, a financial industry contact indicates that there has been a sharper slowdown in the industry than expected, following a robust first quarter: trading volume and profits, as well as debt issuance, have declined noticeably; also, the performance of hedge funds is reported to have been weak in April and May. More generally, this contact indicates that securities industry hiring and overall

spending is likely to slow in the second half of this year.

Manufacturing activity, however, has shown signs of rebounding since the last report. Factory contacts report that business activity has picked up noticeably in recent weeks, after slowing in April and early May; they also continue to be quite optimistic about the outlook for orders and shipments in the second half of 2005. Purchasing managers report mixed results for May: those in the New York City area report some deceleration in manufacturing activity, but Buffalo-area purchasers report ongoing improvement in business conditions. Both groups of purchasers, as well as manufacturing contacts, note some increase in price pressures.

### **Financial Developments**

Small to medium-sized banks in the Second District reported some weakening in demand for consumer loans, but a pickup in demand for residential mortgages--despite continued declines in refinancing activity. Bankers indicate some tightening in standards on consumer loans: 17 percent say they have tightened standards while just 6 percent indicate easing. Bankers note increased interest rates on all types of loans except residential mortgages. Bankers also report increased rates on deposits; nearly four in five bankers indicate an increase in rates, while none reports a decrease. Finally, on balance, loan delinquency rates were unchanged in all categories except consumer loans, where delinquencies declined.

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

Economic activity in the Third District expanded in May, but the pace of growth appeared to ease. Manufacturers reported increases in orders and shipments during the month, although the gains were not as widespread as in April. Retail sales of general merchandise edged down during the month, and auto sales fell. Banks reported that lending continued on an upward trend in May, although at a slower rate compared with April. Commercial real estate market conditions showed little change, although leasing activity has been on the rise. Sales of new and existing homes continued at a brisk pace.

Third District business contacts generally expect improvement in the region's economy in the months ahead, but not a strengthening in growth. Manufacturers expect increases in shipments and orders during the next six months. Retailers anticipate an improved rate of sales during the spring, with modest year-over-year gains. However, auto dealers expect slower sales for the rest of the year. Commercial real estate contacts forecast gradual tightening in office markets. Residential builders and real estate agents expect sales to continue at high rate, but some expect sales for the year as whole to be lower than last year.

### **Manufacturing**

Manufacturing activity in the Third District continued to expand in May, although fewer firms reported growth during the month than in April. Around one-third of the manufacturing firms surveyed had increases in new orders and shipments in May compared with April, and around one-fifth reported decreases. Order backlogs were unchanged from April to May, and delivery times were steady. Growth in business was reported among firms in most of the District's major manufacturing industries, with the most widespread gains being among producers of metal and wood products.

The region's manufacturers generally expect further growth in business activity, although

their expectations are not as robust as they were earlier in the year. Around one-third of the firms surveyed in May expect their shipments and orders to increase during the next six months, and about one-fifth expect decreases. Capital spending plans remain positive, on balance; about one-fourth of the surveyed manufacturers plan to increase capital expenditures in the next six months, half plan steady spending, and about one-tenth plan to reduce capital outlays.

Third District manufacturers reported rising prices in May, on balance, although the number of firms noting increases during the month was lower than in earlier months this year. Firms in all but a few of the major manufacturing industries in the region indicated that they had experienced increased input costs and raised prices for their own products in May compared with April. During the next six months almost one out of two of the manufacturers polled in May expect increases in input prices, and about one out of ten expect decreases. About one out of four plan to increase the prices of their own goods, and around one out of six expect to reduce prices. This represents less widespread expectations of higher prices than in earlier months of the year.

### **Retail**

Retailers generally reported declines in sales in May compared with April. Most said cold and rainy weather deterred sales of spring apparel and other seasonal merchandise. Retailers gave mixed reports on their year-to-year comparisons. Although some posted flat sales or slight gains, several had lower sales than in May of last year. Retailers expect sales growth to resume in the months ahead, but most look for only modest gains. Merchants continue to be concerned that consumers are limiting their buying of general merchandise as they cope with high gasoline prices. Most of the retailers contacted in May indicated that wholesale prices of the goods they are purchasing have been roughly steady, but several store executives noted that fuel surcharges are now common for goods shipped to them.

Auto dealers in the region generally reported declines in sales in May compared with April and with May of last year. Inventories have risen, and a large number of dealers have boosted leasing promotions to move cars off their lots. Dealers do not expect the sales rate to improve, and they believe sales for the year as a whole will be below last year.

### **Finance**

The volume of loans outstanding at Third District banks rose in May compared with April, according to banks surveyed for this report, although some noted slower growth during the month. Commercial and industrial loans have been increasing, and bankers said the new borrowing has been for capital expenditures by firms in a wide range of industries. Lending for residential mortgages, home equity loans, and home equity credit lines was also on the rise. Banks and other mortgage lenders reported strong demand for purchase mortgages, but they indicated that refinancing activity was slower than they had expected. Credit card lending has also been growing, but bankers generally indicated that other types of personal loans have been about flat. Looking ahead, bankers in the District expect continued growth in the regional economy, and they expect overall lending to rise in step with the expansion in business.

### **Real Estate and Construction**

Commercial real estate firms reported that vacancy rates in the region's office markets have been steady in the past few months, and that rental rates have eased slightly. Leasing activity has been fairly strong, but commercial real estate firms noted that tenants were signing for

shorter terms on new or renewed leases. However, some tenants have signed for more space than they currently need, in anticipation of growing business. Commercial real estate agents expect tightening in the region's office markets during the rest of the year. Industrial building vacancy rates have risen slightly in recent months, as speculative buildings have come on the market, but commercial real estate contacts believe demand for space will grow during the rest of the year.

Residential real estate agents indicated that sales have picked up, and that the pace of sales in May was brisk. Although many real estate agents anticipate sales for this year will not match those of last year, they generally believe a high sales rate is likely this summer as long as mortgage interest rates remain around current levels. Homebuilders reported continuing high demand for new homes and large backlogs. House prices continue to appreciate for both new and existing homes. Builders indicated that costs of materials and labor have been rising slightly, and they reported continuing steep increases in land prices.

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## **Fourth District--Cleveland**

Through the eight weeks in April and May, District business conditions continued to show some unevenness across sectors, but were still supportive of growth on net. In the manufacturer sector, activity at the District's durable goods facilities generally continued its recent increases, and for the first time in recent reports, notably more nondurable goods producers indicated improvements in production. Reports from retailers continued to be varied, though discounters saw slightly better sales than earlier this year. Commercial builders continued to report improvements in conditions, though residential builders saw sales continue to decline slightly through April and May. At the District's banks, commercial loan demand remained robust. And demand for shipping services rebounded in recent weeks, after slowing slightly in March and April.

Input cost increases continued to moderate in April and May, though interestingly, some firms appeared more able to pass input cost increases on to their end consumers. Hiring throughout the District remained modest in most industries, though staffing-services companies reported some increases in available openings.

### **Manufacturing**

Production at the District's durable goods facilities continued to increase in April and May, and was typically above year-ago levels. Moreover, most contacts expected conditions to continue to improve throughout the year. Nevertheless, activity at the District's steel facilities fell throughout the eight weeks ending May, and for many firms steel shipments are similar to or less than at this time last year. As indicated in the previous report, contacts again attributed the recent slowing to an accumulation of inventories, customers putting off purchases in the hope of buying cheaper steel, and weakening demand in some sectors, notably automobiles. Weakness in automobile production, however, was less evident throughout the District, where there were gains in year-over-year production for the two-month period ending in May.

In general, nondurable goods manufacturers also reported slight increases in activity in recent weeks, with production levels slightly above those of this time last year. Many firms anticipate steady improvements in production throughout the rest of 2005, though the current

pace of new orders growth does not indicate an improving production trajectory. Firms that supply the auto industry are anticipating weaker production.

As in recent reports, hiring among manufacturers remained modest, with durable goods producers increasing staff sizes more often than their counterparts in nondurable good production. Still, the use of overtime appears to have increased in April and May for durable and nondurable goods producers alike. Firms that attempted to hire noted more difficulty attracting adequately trained candidates. Regarding increases in capital outlays, most contacts indicated that their firms were likely to spend according to their previously budgeted plans. Firms typically indicated that there was a limited need to expand or replace existing equipment, as many had made significant capital outlays over the last few years; few cited the partial-expensing tax provision that expired in 2004 as a significant factor in their decisions.

In general, input cost increases continued to abate, but costs are still up substantially from a year ago. Steel prices, in particular, appear to have fallen noticeably, with prices for some steel products falling below last year's levels. Energy costs, however, continued to increase in recent weeks. Firms continue to have some success passing previous rounds of input cost increases along to their customers.

### **Retail**

The economic environment for retailers continued to be mixed in April and May. The District's discount retailers saw some improvement in sales in recent weeks, though still-high gasoline prices and unseasonably cool weather were thought to have dampened sales somewhat. Most contacts indicated that their sales were unchanged or slightly above year-ago levels. While sales at specialty stores and grocers were above year-ago levels, sales at the District's department stores continued to be below expectations, and were less than at this time last year. Accordingly, department-store contacts cited increases in promotional and markdown activity; this was true for apparel retailers as well.

After improving sales in March and April, District automobile dealerships reported sluggish sales in May. Sales seemed to be much weaker in the District than was true nationally. And for the first time in recent reports, sales trends for trucks and SUVs were poor. Inventories were characterized as high at dealers selling domestic makes. In general, incentives also remained generous at District dealerships.

### **Construction**

Many homebuilders saw a slight weakening in sales in April and May. Relative to this time a year ago, homebuilders typically reported that sales were flat or falling. Contacts that also operate outside of the District indicated that market conditions were weaker in the Midwest than elsewhere. And some builders reported that the market for lower price-point homes was softer than that for other segments. Several contacts reported that their customer cancellation rates had risen higher than their historical average. While increases in materials costs moderated, costs remained above the levels of last year. Most builders do not expect business conditions to change markedly throughout the remainder of 2005.

Nonresidential builders, by contrast, experienced somewhat stronger growth than homebuilders. Most commercial contractors reported an increase in activity in the second quarter, as well as on year-over-year basis. Several builders cited public projects and manufacturing as areas where demand was especially strong. Backlogs are also up for most

builders. Regarding materials prices, steel price pressures have eased, though costs for petroleum-based products have continued to increase in recent weeks. Nevertheless, contractors report that it is easier to pass input cost increases on to their end consumers. Though most firms expect conditions to continue to improve throughout the year, hiring and additional capital investments remain limited.

### **Banking**

At banking institutions in the District, commercial loan demand appeared to strengthen slightly in April and May. One contact noted that the number of its prospective borrowers had grown significantly since the start of the year, and another institution in the District reported its largest ever pool of prospective commercial borrowers. Demand was described as broad-based, with some seasonal increases in demand connected with commercial real estate. By contrast, consumer borrowing was more mixed across District institutions. Some strengthening in the demand for home-equity products and mortgages was mentioned. Banks' core deposits were generally flat or falling, and credit quality continues to be characterized as high.

### **Trucking and Shipping**

The slight softening in this sector's business conditions that was reported for the late winter months continued through the end of April. However, demand reportedly rebounded for trucking and shipping services firms in May. Demand was generally broad-based, though some contacts noted weaker-than-expected demand from firms in the automotive sector. Contacts expect conditions in the industry to remain strong throughout the year--one contact called this period the best in the industry in 20 years--but think that growth will be constrained by an inability to attract and retain workers. Wage rates, nevertheless, remained stable. Fuel costs continue to be high, but have been offset through surcharges. Contacts' capital spending levels were largely driven by the need to comply with coming changes in emissions regulations.

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### **Fifth District--Richmond**

The Fifth District economy continued to expand at a moderate pace in the weeks since our last report. District services businesses reported somewhat faster growth in revenues and employment in both April and May. In retail, sales picked up markedly and store traffic increased sharply in May. Manufacturing also gained some traction; shipments and new orders rose at a more solid pace since our last report, though employment in the sector continued to drift lower. District real estate agents said that residential markets remained vibrant and that commercial leasing firmed in recent weeks. In the financial sector, lending picked up; residential mortgage lending was particularly strong as home sales remained hot in most areas. On the price front, business contacts said that the prices of most goods and services continued to rise only modestly. In agriculture, cooler-than-normal spring temperatures hampered planting activity in some areas, but crop conditions were generally good throughout the District.

### **Retail**

Retail sales growth picked up in April and May. District retailers told us their stores were busier in recent weeks and they were expanding sales staff as a result. Sales at building supply stores were particularly strong and contacts reported that rising sales had prompted

increased hiring. Although sales rose at a number of District big-ticket retailers, the gains were concentrated in men's apparel, sporting goods, and building supplies, rather than in automobiles and furniture. District retailers told us that prices continued to rise at an annual rate of less than 2 percent.

### **Services**

District services firms reported moderately higher revenues in recent weeks. Public utilities in South Carolina and West Virginia said unseasonably cool weather had prolonged the demand for heat through May. Several District healthcare services firms reported an increase in business. Contacts at hospitals and home healthcare businesses in eastern North Carolina and southwestern West Virginia said that stronger sales had led them to increase staffing. Employment in the services sector continued to rise only moderately although wage gains were larger than earlier in the year. Price increases at service-producing firms remained modest.

### **Manufacturing**

District manufacturing activity expanded at a slightly faster pace since our last report. Manufacturers said shipments grew more quickly, while new orders increased modestly and capacity utilization moved higher in April and May. Industrial machinery, paper, and transportation equipment manufacturers registered the strongest gains in output. Despite increased shipments, factory employment continued to decline, especially in the chemicals and furniture industries. A Carolina furniture manufacturer said that his shipments, new orders, and payroll fell in May and that retail furniture sales had declined nationwide. Raw materials prices rose at a quicker pace in recent weeks and a number of District manufacturers expressed concern about razor-thin profit margins. "Raw materials costs are escalating faster than we can pass them along to customers," lamented a North Carolina plastics manufacturer.

### **Finance**

District bankers said demand for loans strengthened somewhat in April and May. Increased residential mortgage lending was spurred by continued robust home sales in many areas of the District; mortgage refinancings remained subdued. Real estate agents said that a growing number of clients expressed interest in purchasing a house for investment purposes or as a second home rather than as a primary residence. Mortgage interest rates drifted lower in April and May, dropping well below 6 percent for conventional 30 year mortgages. "Mortgage interest rates have fooled people, staying as low as they have. They've helped to sustain the market," noted a Richmond, Va., lender. Commercial lending was generally higher as well, bolstered by a pickup in merger and acquisition activity in some instances. But the pace of commercial lending slowed in a few areas. A Charlottesville, Va., banker said that his cold calls to solicit commercial loans had "gotten a lot colder" in recent weeks.

### **Real Estate**

Residential real estate agents in the District generally reported stronger housing markets and rising home prices in recent weeks. In Richmond, Va., an agent reported "extremely" strong house sales, noting that listings at his agency were the highest they had ever been and that multiple offers for homes remained common. In Virginia Beach, Va., an agent said "everything is popping!" He said that sales across the board were great, noting that he had sold over \$12 million in properties in ten days. Likewise, contacts in Fredericksburg, Va., and Washington, D.C., characterized markets as very strong. Both said, however, that sales of upper-price-range homes had slowed a bit. An agent in Greensboro, N.C., also experienced

some slowing in sales of upper-end homes. Despite softer upper-end activity, sales prices continued to rise at a brisk pace in many areas of the District.

Commercial real estate agents reported a strong increase in Fifth District leasing activity in April and May. Contacts said that office and retail leasing accounted for the bulk of recent activity. In the Washington, D.C., market, demand for investment properties and lease space remained strong--one local agent summed up the environment by stating, "There are too many developers chasing too few sites and too much money chasing too few deals." Contacts in Raleigh, N.C., and Richmond, Va., said that commercial markets were "in a good place"--leasing strengthened in both areas. Commercial leasing also moved higher in Columbia, S.C., and contacts there noted with relief that military bases in the area had been spared in the most recent round of base closings. "If we had lost those bases then we could have just locked the doors and gone home," commented one agent. Commercial rents firmed throughout the District and new construction rose in many urban areas in April and May.

### **Tourism**

Tourism picked up a bit since our last report. Contacts at hotels along the District's coast noted that bookings for the Memorial Day weekend were somewhat stronger than a year ago. But not all contacts characterized tourism as strong. Several contacts along the coast said that they had to discount rooms substantially to attract vacationers, many of whom, they noted, were quite savvy at shopping for price discounts on the Internet. Tourism in Washington, D.C., continued to rise and hotel occupancy rates there have returned to pre-September 11 levels; surging demand for hotel rooms in the nation's capital has driven room rates sharply higher in recent months.

### **Temporary Employment**

Contacts at employment agencies reported stronger demand for temporary workers in April and May. A Washington, D.C., agent told us that the local economy continued to improve, boosting demand for temporary workers and wages. The president of a staffing agency in Raleigh, N.C., said that many local companies were searching for permanent employees, and he expected wider use of his firm's "temp-to-hire" option, which allows companies to hire an employee on a permanent basis after a 13-week trial period.

### **Agriculture**

Cooler-than-normal temperatures slowed the planting and development of selected District crops in recent weeks. Cantaloupe, tomato, and watermelon plantings were well behind schedule in Maryland, while plantings of peanuts and cotton were slightly behind in Virginia. Agricultural analysts characterized crop conditions as "fair to good" throughout the District, despite dry conditions in some areas of Virginia and the Carolinas. Small grain harvesting began in the Carolinas and, based on early estimates, yields were average.

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## **Sixth District--Atlanta**

Most Sixth District business contacts reported that the pace of economic activity was solid in April and May. Residential housing sales and construction remained strong, while conditions in commercial real estate markets continued to improve. Reports from the tourism and hospitality industry remained upbeat, with hotel/resort occupancies at high levels. However, retail and auto sales were more mixed than a year earlier. Several manufacturing sector

contacts reported strong demand, but many also noted that high energy prices were affecting profit margins. Banking contacts reported that loan demand remained strong throughout the District and credit quality was good. Labor markets tightened in some areas for construction workers, while temporary hiring remained robust. Contacts continued to note price increases in building materials and energy, and several reports noted service-related price increases in transportation and healthcare.

### **Consumer Spending**

According to reports from District contacts, retail sales during April and May were mixed compared with strong reports from a year ago. Florida merchants remained the most positive, while retailers in other parts of the District reported that sales ranged from slightly down to up modestly compared with a year ago. Several noted that sales results in May fell below expectations, and many blamed cool or wet weather conditions for the lackluster results.

District auto sales were also mixed in April and May. Most contacts noted that demand for foreign brands remained strong, while domestic models lagged. A domestic industry contact blamed the disappointing performance of U.S. brands on sluggish sales of large trucks and some SUV models, which may be linked to reports that fuel efficiency was becoming a more important factor for most buyers.

### **Real Estate**

District real estate markets were little changed in April and May. Residential construction and home sales continued to be strong, especially in Florida where shortages of homes for sale continued to be noted. The pace of condominium development remained very strong along the coasts, most notably in South Florida. Solid improvements continued to be reported in District commercial real estate markets as firms moved ahead with expansion plans and absorption of existing space remained positive.

### **Manufacturing and Transportation**

Reports from the factory sector were mostly positive, although high energy prices were adversely affecting some firms. Several firms reported that they were running at capacity and were adding to payrolls. Some also noted that they were going ahead with capital investment plans, including expansion. New military contract awards continued to boost District factory activity. Some contacts noted that many manufacturers are unable to pass along rising costs of raw materials because of long-term contracts that are in place, but those that could pass through price increases were doing so.

District transportation contacts generally continued to report good freight demand, although one contact noted a deceleration in activity after a strong first quarter. Airborne shipments in March and April were weaker than last year in Miami and Atlanta airports.

### **Tourism and Business Travel**

Reports from the tourism and hospitality sector were upbeat in April and May. Tourism-related businesses in South Florida reported very strong sales with hotel occupancies holding strong. Contacts expected that the surge of foreign visitors will continue to boost the South Florida economy well into the summer. Central Florida resort attendance was said to be very strong and tax collections from those areas continued to rise. In Southwest Florida, hotel occupancy levels remained high with European travel to the area up by double digits from a year ago. Many major gaming industry properties along the Mississippi Gulf Coast continued significant upgrades and additions.

## **Banking and Finance**

Overall loan demand in the District remained strong. In parts of the District, anticipation of higher interest rates appears to have accelerated some loan activity. There were no reports of a slowdown in consumer finance. Real estate loan volume remained on track in most parts of the District. Credit quality remained good with delinquency rates in check, and banks are reportedly expecting higher profits in the second quarter of the year.

## **Employment and Prices**

Contacts in parts of the District reported that construction employment remained tight, with continued labor shortages in electricians, plumbers and flooring laborers. Hiring remained strong for temporary workers. Many manufacturing firms reportedly now have temporary workers that do a variety of jobs that were once done by permanent employees.

Contacts reported that prices of construction materials continued to rise with a new round of increases for some building products expected in July. Reports from across all business lines reported that profits were being squeezed by high energy costs, especially in the manufacturing and transportation sectors. Healthcare and hotel prices were also reported to have risen recently.

## **Agriculture**

Dry weather improved fieldwork activity through the end of May with conditions of most regional crops averaging between fair and good. The District cotton crop progressed well, but the outlook weakened as world-market prices recently dropped. Poultry exports were strong in volume and price as global demand for chicken continued to increase.

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## **Seventh District--Chicago**

Seventh District business conditions in April and May were similar to conditions during the previous reporting period; the economy continued to expand at a moderate pace, though activity lagged in Michigan. Consumer spending was again generally subdued, while business spending continued to increase. Residential construction remained solid, and commercial real estate development increased at a steady pace in many parts of the District. Manufacturing activity continued to expand, though the rate of increase slowed in many industries. Lending activity to both businesses and households picked up from the previous survey period. There were reports of price increases throughout the supply chain, but overall cost and price pressures were moderate. Spring planting proceeded quickly, but farmers expressed some concerns about slow crop development due to cool weather and, in many parts of the District, inadequate rainfall.

## **Consumer Spending**

Consumer spending was again generally subdued. Retailers reported that sales in the Midwest during May were weaker than in other parts of the country and below expectations, in part because of unseasonable weather. One contact said that sales of home and garden merchandise were especially slow. As a result, inventories of these goods were heavy, but the contact believed sales would pick up as the weather improved in June. Auto dealers' characterizations of new vehicle sales in May ranged from "OK" and "decent" to "tough." Vehicle inventories remained high. A large restaurant chain noted that sales in the Midwest were still strong, but not as robust as at the end of last year. Tourism contacts in Chicago

reported positive conditions, while those in Michigan reported a sluggish pace of spending, in part due to the colder weather in May. Hotels in Michigan said that summer reservations were running below year-ago levels, but they remained optimistic and speculated that travelers had grown more willing to make plans on short notice.

### **Business Spending**

Business spending continued to increase. A majority of contacts planned to expand capital spending during the next twelve months, and reports of decreases in investment were sporadic. Trucking volumes moderated some, particularly for consumer goods; nonetheless, one industry analyst forecasted a pickup later in the year. Labor market conditions continued to improve, with several contacts indicating that job openings had increased. Demand reportedly firmed for workers in professional services, health care, and, to a limited extent, some manufacturing industries. In contrast, layoffs occurred at a large retailer, a food manufacturer, and an auto supplier; and a large staffing services firm reported a small decline in demand for temporary workers relative to a year earlier. Truck drivers were easier to find. However, other skilled workers--notably in manufacturing--were in short supply, and one staffing firm said that businesses were more willing to pay direct-hire fees to fill openings.

### **Construction and Real Estate**

Reports on construction and real estate activity were mixed by location and market segment. Residential construction continued to be solid overall, though it showed signs of moderating in some parts of the District. The supply of unsold single-family homes fell slightly in Milwaukee, but ticked up in the Detroit area. Commercial real estate development continued to expand at a steady pace in many parts of the District. However, one contact in Michigan noted a further slowdown in commercial development there and attributed the decline to the weak performance of the auto industry. On balance, commercial vacancy rates and rents were stable. Some further declines in vacancies were reported in suburban Chicago, but contacts expressed some concern about excess space in parts of Iowa.

### **Manufacturing**

Manufacturing activity continued to expand in the District during April and May, though the rate of increase slowed in many industries. Heavy machinery producers reported slower growth in shipments for equipment. Activity in the steel market was reportedly "sluggish and slowing down," which one contact attributed to heavy inventories at service centers. A toolmaker reported some slowdown in orders, but added that bookings remained healthy and demand from abroad was increasing. Shipments of wallboard and cement continued to increase, and contacts in both industries reported high capacity utilization rates. Cement inventories were said to be extremely tight nationwide, though an increase in imports had reduced the number of shortages in the southeast. Manufacturers also reported continued shortages of large tires, some specialized steel products, foundry castings, bearings, and titanium. The light vehicle sector remained weak. Automakers revised down overall third-quarter production schedules from their earlier plans and shifted around product mix. Nonetheless, contacts remained optimistic and maintained their forecasts for light vehicle sales to firm later in the year. An analyst in the heavy truck industry noted a softening in orders, though order backlogs remained high and build rates continued to increase.

### **Banking and Finance**

Lending activity picked up from the previous reporting period. Business loan demand continued to improve, with broad-based gains across market segments and loan types. Business credit quality was generally stable or slightly better: one contact noted

improvements in non-accruing loans and the number of assets on its watch list. Several contacts noted that standards and terms for commercial loans remained fairly generous due to competitive pressures, but they added that there had been no further easing. Household loan demand ticked up during April and May. Demand for home-purchase mortgages remained strong and applications for mortgage refinancings increased slightly. Consumer credit quality was generally good and little changed from earlier in the year. Contacts reported that spreads for business and household loans remained narrow due to competitive pressures.

### **Prices and Costs**

There were reports of price increases throughout the supply chain, but overall cost and price pressures were moderate. A number of manufacturers noted higher prices for inputs such as energy, resins, and plastics, but prices for finished steel declined somewhat. Manufacturers reported some success in raising the prices of their products to cover higher costs. However, one heavy machinery producer said customers recently showed more resistance to price hikes than they had earlier in the year. One appliance maker was focusing on covering their cost increases through productivity improvements. At the retail level, reports of price increases were still sporadic, but they outnumbered the reports of price declines. Wage gains remained modest. The state of Wisconsin raised the minimum wage at the beginning of June, affecting 2 percent of the state's workforce.

### **Agriculture**

Spring planting proceeded at a quick pace, inducing some shift in acreage from soybeans to corn. Corn development was slightly behind a year ago in all District states, though ahead of the 5-year average. Soybean emergence lagged last year's pace in Indiana and Iowa, but was close to the 5-year average in most of the District. Moderate drought conditions stretched from central Illinois into Michigan, with much of Wisconsin and northern Indiana behind on precipitation as well. Conditions to date have likely ruled out a repeat of last year's extremely high yields, but timely rainfall this summer could still produce a good harvest. As poor weather pushed up futures prices, more farmers locked in prices on at least part of their fall harvest. Some farmers, worried about "hot spots" and other problems with corn currently in storage, sold it rather than wait for higher prices. Hog prices moved up during the reporting period, but milk and cattle prices declined. Farmland values in the District increased 4 percent from the fourth quarter of 2004 to the first quarter of 2005.

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

The economy of the Eighth District has continued to expand since our previous survey. A majority of manufacturing contacts reported plans to open plants and increase operations. The services sector continued to expand. Retail sales in April and May increased over year-earlier levels, but auto sales declined over the same period. Home sales continued to increase, and commercial real estate market conditions were mixed. Lending conditions at a sample of District banks have varied slightly in the past three months.

### **Consumer Spending**

Contacts reported that retail sales in April and May increased over year-earlier levels. While 45 percent of the retailers surveyed noted that sales levels met their expectations, 35 percent reported that sales were below what they had anticipated, and 20 percent reported sales above expectations. Gardening items, shoes, clothing (especially children's), food, and jewelry were

all strong sellers, while home decor, seasonal items, and hardware were moving more slowly. About half of the contacts noted that inventories were at desired levels, while 38 percent reported that inventories were too high. Retailers are generally optimistic about summer sales.

Car dealers in the District reported that sales in April and May decreased compared with last year. About 46 percent of the car dealers surveyed reported decreases in sales, while another 46 percent reported increases. About 35 percent of the car dealers noted that used car sales had increased relative to new car sales, and about 37 percent reported increases in low-end vehicle sales relative to high-end vehicle sales. About 80 percent of the contacts reported no change in the use of rebates. Over half of the respondents reported unchanged acceptance rates of finance applications, but 29 percent noted more rejections. About 57 percent of the car dealers surveyed reported that their inventories were at desired levels, and one third of contacts reported that their inventories were too high. Half of the contacts anticipate increased summer sales over 2004.

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

Manufacturing in the Eighth District continued to show signs of moderate improvement, with a majority of firms reporting plans to open plants and expand operations. Several contacts expressed concern over higher fuel and steel input prices. Firms in the primary metal, furniture, motor vehicle, household appliance, coal product, aerospace, chemical, pharmaceutical, plastics, and medical supplies industries reported plans to open new plants or expand operations. Contacts in the steel, electrical equipment, and chemical manufacturing industries reported increased orders and higher earnings in April and May from a year ago. Despite these improvements, several District manufacturers reported plant closings and workforce reductions. Firms in the motor vehicle industry reported plans to temporarily shut down operations because of excessive inventories and decreased demand for sport utility vehicles.

The District's services sector continued to expand. Firms in the freight transportation, business support, management consulting, recreation, warehousing, and health services industries reported new facility openings and expansions. Several regional business contacts noted strong sales and employment gains in the hospitality services industry. In contrast, several firms in the financial and educational services industries reported plans to close facilities or lay off workers.

### **Real Estate and Construction**

Home sales are still on the rise in the Eighth District. Compared with 2004, April year-to-date sales rose 5 percent in Louisville, 4.2 percent in Memphis, and almost 1 percent in St. Louis. Residential construction is lagging in most of the District's metro areas. April year-to-date single-family residential permits were down from 2004. Permits declined 8.3 percent in St. Louis, 4 percent in Memphis, and about 14 percent in Evansville, Indiana, and Jackson, Tennessee. In contrast, permits in Louisville and Little Rock increased over 9 percent.

Commercial real estate market conditions throughout the District were mixed. The first-quarter industrial vacancy rate in Memphis fell to 18.2 percent from 18.7 percent in the fourth quarter of 2004; in St. Louis, the industrial vacancy rate fell to 6.4 percent from 6.6 percent; in Louisville, however, the industrial vacancy rate rose to 8.5 percent from 7.4 percent. Office vacancy rates in the District declined slightly. The first-quarter office vacancy

rate in Memphis declined to 18.6 from 18.7 percent in the fourth quarter of 2004, while the St. Louis office vacancy rate remained at roughly 16 percent. Contacts reported no new commercial construction permits issued in April for Texarkana, Arkansas. Contacts in northeast Mississippi reported that new commercial space increased in the first quarter of 2005 compared with a year ago. In west Tennessee, contacts reported numerous manufacturing plant expansions.

### **Banking and Finance**

A recent survey of senior loan officers at a sample of District banks indicates little variation in overall lending activity in the past three months. During this period, credit standards for commercial and industrial loans were somewhat tighter, while demand remained unchanged. Credit standards for residential mortgage loans, commercial real estate loans, and consumer loans were generally unchanged. Respondents indicated that the demand for commercial real estate loans was somewhat stronger, while the demand for consumer loans was somewhat weaker.

### **Agriculture and Natural Resources**

Because of good conditions in April and May, planting of all major District crops is ahead of their five-year average pace, with soybean and sorghum significantly ahead of normal. Recent cool and dry weather, however, has slowed growth of crops and pastures. In addition, over half of the soil moisture ratings in Arkansas, Illinois, Missouri, and Tennessee were reported to be less than adequate at the end of May.

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## **Ninth District--Minneapolis**

The Ninth District economy displayed moderate growth since the last report. Growth was evident in consumer spending, manufacturing, construction, energy, and mining. However, agriculture and real estate were mixed, and tourism was flat. Employment grew modestly, and wages grew slightly. Significant price increases were noted in health insurance, natural gas, and cement.

### **Consumer Spending and Tourism**

Overall consumer spending increased moderately. A North Dakota mall manager reported April sales up more than 7 percent from a year ago; May started slower but was picking up toward the later part of the month. A major Minneapolis-based retailer reported same-store sales up 5.1 percent in May compared with a year ago. A Minneapolis area mall manager characterized recent traffic as quiet, while a St. Paul area mall manager noted that there were "no big swings one way or the other." The number of foreign travelers visiting a major mall in the Minneapolis-St. Paul area increased to 6 percent of all visitors this year, up from 3 percent two years ago. Apparel sales were generally slow throughout the district due to unseasonably cool weather.

A St. Paul area auto dealer noted sales of domestic cars and trucks were down over 30 percent in May compared with a year ago. A representative of an auto dealers association in Minnesota reported that sales in late April and May were down from a year earlier.

Spring tourism was flat due to cool weather, but tourism officials are optimistic for the summer season. Recent hotel occupancy in St. Paul was down slightly from a year ago. According to an official, South Dakota tourism activity was slower in April and May

compared with last year, but picked up during Memorial Day weekend; inquiries and advance bookings for the summer season were higher than a year ago. Bookings, reservations, and Web site visitor totals were at encouraging levels for Montana's summer tourism season, which is expected to increase 2 percent over last year.

### **Construction and Real Estate**

Activity early in this year's construction season was solid. Construction for industrial space has shown signs of picking up in the Minneapolis-St. Paul area during 2005, according to a report from a commercial real estate firm. The U.S. Congress approved \$80 million for military-related construction projects in Montana. Contract awards for large construction projects in Minnesota and the Dakotas were up 16 percent during the first quarter compared with the same period a year ago. However, during the three-month period ended in April, housing units authorized in district states were down 7 percent compared with the same period a year ago.

Real estate markets were mixed. Home foreclosures through April were up 17.7 percent in the Minneapolis-St. Paul area from the same period a year earlier. A St. Paul Realtor reported market time for selling houses increased slightly, and sellers must often make concessions on their asking prices. However, residential real estate markets in some other district cities, such as Fargo, N.D., and Duluth, Minn., remained strong. The Minneapolis-St. Paul commercial office market continued to recover, and growth in the industrial real estate market remained at a strong pace.

### **Manufacturing**

Manufacturing activity expanded. A May survey of purchasing managers by Creighton University (Omaha, Neb.) indicated significantly increased manufacturing activity in the Dakotas and level activity in Minnesota. The survey indicated that durable goods manufacturing was gaining momentum. An informal survey of contacts revealed that most manufacturers plan to increase capital investment due to high sales expectations and little excess capacity. In South Dakota, a backhoe manufacturer recently announced a major expansion plan. In North Dakota, a soybean crushing plant is in the design phase. A defense manufacturer is building a new facility in Minnesota. However, a major automobile assembly plant in Minnesota furloughed workers for several weeks since the last report.

### **Energy and Mining**

Activity in the energy and mining sectors increased. Oil and gas exploration and production increased significantly from early April through mid-May. In southern Minnesota, construction of a biodiesel plant is currently under way and another is planned. Mines across the district are producing at near full capacity. Expansions of existing mines and several new mines are planned in the district.

### **Agriculture**

Economic activity in the agricultural sector was mixed. District farmers had problems getting in the fields to plant, and row crop development is below a year ago. The honey bee population is down significantly due to mite infestations, which may inhibit the pollination of district fruits, vegetables, and nuts. However, a bountiful winter wheat crop is expected in Montana and South Dakota, and the progress of the spring wheat and other small grain crops is significantly ahead of the five-year averages. Prices for many district agricultural commodities decreased in May compared with a year ago. The U.S. Department of Agriculture projects that prices will continue to drop into 2006 for corn, soybeans, wheat,

milk, cattle, and hogs. Meanwhile, precipitation increased across the district, which reduced the severity of the drought. Agricultural land prices continue to increase. For example, the USDA reports that the average price of Minnesota farmland is up 12 percent from a year ago.

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

Overall employment grew slightly. In Minnesota, a disk drive manufacturer expects to add 100 jobs this year due to strong demand, and a bottled soft drink sales and distribution center has recently added 95 jobs. A computer component plant in Eau Claire, Wis., has recently added about 300 workers. Members of the Minneapolis Fed's Advisory Council on Small Business and Labor noted that certain businesses were having difficulty finding qualified workers. A truck driver shortage was reported in several parts of the district.

In contrast, a brokerage and investment bank based in Minneapolis plans to lay off 90 people this summer. Also in Minnesota, a freezer plant laid off 130 workers, an electronics manufacturer recently reported plans to cut about 80 workers, and a circuit board plant closed, ending 60 jobs in the northern part of the state.

Wage increases remained modest. A Montana bank director noted that manufacturing businesses expect to increase wages slightly, tempering increases to compensate for higher health insurance premiums. Farm operators in an area including Minnesota and Wisconsin paid hired workers slightly less in April compared with a year earlier.

While price increases for consumer goods were generally moderate, significant increases were noted in health insurance, natural gas, and cement. Members of the Minneapolis Fed's Advisory Council reported that costs for several raw materials were well above year-ago levels; however, many businesses were not able to pass increases along to customers. A bank director noted that year-over-year health insurance cost increases were above 10 percent. Natural gas prices recently increased 15 percent to 30 percent above year-ago levels. Prices for cement recently increased and are about 10 percent higher than a year ago. Steel mill product prices decreased during the past few months, but were still nearly 20 percent higher than a year ago. Gasoline prices in Minnesota at the end of May were slightly lower than a year ago.

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

The Tenth District economy expanded moderately in late April and May. Consumer spending rose solidly, labor markets continued to firm, and commercial real estate activity improved slightly. In addition, energy activity and residential real estate activity remained at high levels. Manufacturing activity showed little growth following two years of expansion. Agricultural conditions weakened somewhat. Wages and retail prices rose modestly, while wholesale price pressures eased slightly.

#### **Consumer Spending**

Consumer spending in the district expanded solidly in late April and May. Most retailers, mall managers, and restaurants reported increased sales since the previous survey despite a modest negative impact from high gasoline prices. Sales were generally higher than a year ago and at or above plan for the period. Sales of many types of apparel were characterized as particularly strong, while sales of home items were weak at several stores. A number of stores increased inventories since the previous survey, and most managers are now satisfied

with current stock levels. Nearly all store managers were optimistic about sales this summer. Motor vehicle sales were flat compared with the previous survey and were below plan at many dealerships. Sales generally remained slightly weaker than a year ago. Sales of large SUVs and trucks were reported as weak in most areas, while smaller and more fuel efficient models sold well. A number of dealers also reported solid sales of used vehicles. Virtually all dealers expect some improvement in vehicle sales in the months ahead. Travel and tourism activity in the district improved further in late April and May. Nearly all hotels reported increased occupancy rates since the previous survey, and occupancy rates in some locations were at the highest level in several years. Most hotel and resort operators were optimistic about summer travel activity, expecting little if any impact from high gasoline prices.

### **Manufacturing**

District manufacturing activity was largely stable in late April and May following two years of expansion. Plant managers reported little growth in production and employment since the previous survey. However, factory activity generally remained well above year-ago levels. Several firms noted increased supplier delivery times, as truckers were avoiding less-than-truckload shipments in an effort to control costs. Some factories were also delaying their own shipments to ensure full truckloads. Most plant managers remained optimistic about the future, and a sizable share of factories plan to expand their workforces in the months ahead. Many firms also plan to increase capital spending in the second half of the year, due to expectations of increased sales and the need to expand and replace plant and equipment.

### **Real Estate and Construction**

Residential real estate activity remained solid in late April and May, and commercial real estate activity improved slightly. Builders reported that home starts were generally unchanged since the previous survey and down slightly from year-ago levels, although still high by historical standards. Most builders expect new home construction to remain flat in the months ahead. Real estate agents reported increased home sales from both the previous survey and a year ago. As in the previous survey, agents in several cities noted that sales were being boosted in part by out-of-state investors. Home prices were reported as increasing at moderate rates throughout the district. Most agents expect slight increases in home sales and home prices in coming months. Mortgage lenders generally reported increased mortgage demand since the previous survey. The increase was driven by higher demand for home purchase loans, as refinancing activity was flat. Overall, mortgage lenders remain optimistic about future demand for home purchase loans. Commercial real estate activity in the district improved slightly in late April and May. Vacancy rates edged down in several cities, and prices and rents for office space were up modestly. Commercial real estate agents expect activity to be stable or to improve slightly in the months ahead.

### **Banking**

Bankers report that loans edged up and deposits decreased slightly since the last survey, raising loan-deposit ratios somewhat. Demand rose slightly for commercial and industrial loans and commercial real estate loans but edged down for consumer loans. On the deposit side, demand deposits, other checkable deposits, and large CDs edged down, while other types of accounts held steady. Almost all respondents increased their prime lending rates since the last survey, and most respondents raised their consumer lending rates. Lending standards were unchanged. Banks do not plan to increase capital spending in the second half of the year, in some cases because they invested heavily in information technology in 2004.

### **Energy**

District energy activity remained strong in late April and May. The count of active oil and gas drilling rigs in the region was basically unchanged from the previous survey but still much higher than in recent years. Most drilling firms expect moderate expansion of drilling activity in the months ahead, as energy prices are expected to remain high. In addition, several contacts noted improved conditions in the coal industry in Wyoming since the beginning of the year, as both spot and futures prices for coal have risen considerably.

### **Agriculture**

Agricultural conditions in the district weakened somewhat in late April and May. A late freeze and heavy spring rains complicated spring planting in certain areas and forced some producers to replant crops. In addition, producers reported that the condition of the winter wheat crop had deteriorated somewhat since the previous survey due to drought and freeze damage. Pastures, on the other hand, were in good condition, providing adequate spring forage. Farmers' capital spending for the rest of the year is expected to decline somewhat from a year ago due to the higher cost of fuel and fertilizer and lower farm incomes this year.

### **Labor Markets and Wages**

Labor markets in the district continued to firm in late April and May, but wage increases remained modest. Private sector hiring announcements since the previous survey exceeded layoff announcements by a sizable margin. In addition, the military base realignments announced in May were expected to boost both military and civilian employment in the district. The percentage of firms reporting worker shortages was slightly less than in recent surveys. However, several types of workers were still reported to be in short supply, including truck drivers, rig workers, welders, machinists, and both entry-level and experienced retail workers. In addition, college placement offices in the region reported a solid increase in job offers compared with recent years. Firms generally reported that wage increases remained modest, but some contacts said benefit costs rose more than normal.

### **Prices**

Modest price pressures persisted at the retail level in late April and May, while price pressures eased somewhat at the wholesale level. As in the previous survey, most retailers reported flat selling prices, but a sizable number raised their selling prices or delivery charges to offset increased costs. A sizable number of stores also plan to raise prices in the months ahead. Several builders reported increased costs for framing materials, and some expect these increases to persist. Fewer manufacturers than in recent surveys reported rising materials costs, and one firm said chemical prices had fallen due to weaker demand in Asia. Plant managers generally expect moderate increases in materials prices heading forward. The share of manufacturers raising output prices was also lower than in the previous survey, but many plant managers still expect to raise output prices in the months ahead.

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## **Eleventh District--Dallas**

Eleventh District economic activity continued to expand. Manufacturing continued to be mostly strong but with some patches of softness. The service sector showed signs of picking up, while retail sales were up modestly. Construction and real estate activity remained unchanged at a high level. Financial service contacts said loan growth and credit quality remained good. Activity in the energy industry remained very strong, and contacts are very optimistic, but there is a lot of discussion about how long high prices can last. Agricultural

conditions are favorable.

## **Prices**

Contacts in most industries expressed concerns about high energy, fuel and freight costs biting into consumer demand and profits. Competitive pressures are limiting firms' ability to pass rising costs to their customers. Some companies are finding ways to reduce consumption. For example, a retailer said that they have "reengineered standards" to reduce use of petroleum-based products, such as using plastic shopping bags that are smaller and thinner. Other firms say they are continuing to find ways to increase labor productivity to counter rising input costs.

Crude oil prices have varied from less than \$50 to more than \$55 per barrel. Demand for gasoline was down compared to earlier this year and is now more similar to a year ago. Gasoline inventories are high; 4 percent above the 5-year average and at the highest level since May 1999. Natural gas prices fell from over \$7.50 per million Btu to near \$6.50. Natural gas inventories continued to grow and are now more than 20 percent above the 5-year average.

There were reports of rising fees for business services, such as accounting and legal. Prices for manufactured goods were mixed. Prices were up for construction-related materials, such as lumber, cement, brick, tile and glass. Primary metal manufacturers said that high energy and raw material costs have led to some price increases, but persistently idle international capacity and a recent softening in steel and aluminum prices have reduced the threat of a price-rise in the near future. Paper producers say that heavy inventories have pushed down prices. Prices have fallen for all of the basic chemicals and most plastic intermediates.

## **Labor Market**

The labor market continued to strengthen, with more reports of hiring at all levels. Wages were rising in the service sector, but there were few reports of rising wages for nonprofessional workers. Nearly all contacts expressed concerns about the high cost of benefits, particularly health care, and some said that these costs are restraining hiring. Skilled workers were in short supply in the energy industry, and a few industries reported that management level workers were being bid away.

## **Manufacturing**

Manufacturing activity was mixed. Demand was up for construction-related products, including lumber, cement, brick, tile and glass. Contacts attributed the increase to continued robust construction activity, specifically strong housing starts and some commercial and infrastructure work. Cement is in short supply and is on allocation in some areas. Producers of fabricated metals reported solid sales, stimulated in part by increased demand to support construction activity and to supply the construction of wind turbines to generate electricity.

Demand for food products continued to be strong. Apparel manufacturers said demand has been growing over the past month. In the last six weeks, one firm has hired 100 new workers overseas and about 30 domestically. Respondents in high-tech manufacturing said that growth in orders has increased slightly since the last survey. Much of the pickup occurred in the consumer sector. Sales to industrial customers continued to grow at a moderate pace. Telecommunications manufacturers reported a slight increase in demand.

Demand for corrugated boxes softened slightly. Contacts say there is still overcapacity in the industry and competitive pressures may cause some businesses to close. Demand had also

softened for primary metals, although demand remained higher than a year ago.

Chemical producers reported an unexpected slow down in demand from Asia, particularly China, and inventory has shifted from shortage to oversupply. Contacts say the slowdown is not severe but was not expected. Production was reduced slightly but remained at high levels. Refining utilization rates on the Gulf Coast were hurt by a series of outages. Refined product imports were at the highest levels of the last five years and 9 percent higher than last year.

### **Services**

Temporary staffing firms reported increased activity, up significantly from year-earlier levels, with almost all areas performing well. Demand for telecommunications services was up slightly, with continued strong demand for wireless services. Demand for legal services has been steady, driven mostly by corporate transactions, real estate deals and litigation work. Accounting firms reported mixed results.

The transportation industry continued to report strong demand and serious concerns about high fuel costs. Railroads say the strongest demand is for shipping metallic ores, crushed stone, construction products and trailers. Contacts said rail shipping rates continued to rise, but the pace of increase seemed to be slowing. Trucking activity also remained strong and above year-ago levels. The airline industry continued to report strong demand in domestic markets but limited ability to raise prices, although carriers reported slightly higher fares in some markets. Carriers are moving capacity to international routes because fares are higher.

### **Retail Sales**

Retail sales increased modestly. Contacts said sales growth continued to be dampened by high gasoline prices biting into consumers' pocketbooks. Retailers that issue their own credit cards say credit quality trends are positive, with low delinquencies. Auto sales were mixed, and some dealers reported that inventories are higher than desired.

### **Construction and Real Estate**

Housing markets were strong overall, but there continued to be reports of slowing from last year's pace in some metropolitan areas. Home sales are about even with last year's levels, but builders in Dallas and Houston said new home construction has outpaced demand. Rising input costs continued to put pressure on builders' margins because heavy competition has left no room for price increases. Austin remained an exception, where sales have picked up from last year's rate and builders are able to raise prices. Existing home sales were strong across the District, except in Dallas, where sales have slowed and dipped below last year's levels. Contacts are optimistic that recent job gains will spur a pick up in sales.

Demand for apartment space increased in Dallas and Houston but continued to be overshadowed by what many perceive as excess development. Rent concessions have picked up, especially in Houston. Contacts said Austin's multifamily housing market is not overbuilt, but they also expressed concerns about the possibility that new development under consideration could generate an oversupply.

Office markets continued to improve and the pace has picked up slightly, according to contacts. Dallas, Houston and Austin have witnessed positive absorption so far this year. Contacts say investment activity is at a record high.

### **Financial Services**

Loan growth remained solid, and credit quality is good, according to contacts. The market is

extremely competitive, however, and pricing remained a challenge. Respondents are optimistic about the economy and future loan growth. Still, contacts expressed concern about a potential glut in multi-family residential properties, and the possibility of some land price bubbles, particularly in rural areas located near big cities.

### **Energy**

Drilling activity remained strong, with little change in the number of working rigs. In the United States, more rigs have turned to natural gas as the market for rigs has tightened, and only about 11 percent are now directed to oil. International drilling continued to pick up.

Demand for oil field services has been very strong. According to contacts, oil field service companies are raising prices rapidly, and margins are improving. Backlogs are long, and companies are turning down work. Capacity is being expanded in critical areas. Day rates are skyrocketing for land and offshore rigs. Skilled workers are the critical constraint in any effort to expand, according to contacts, who say engineers, truck drivers and drilling crews are particularly in short supply.

### **Agriculture**

The planting season continued to progress well, and most planted crops are thriving, according to contacts. High fuel, irrigation and fertilizer costs remain a serious concern for farmers. The cattle industry is profitable, according to ranchers, who say they are expanding their cow-calf herds. Pasture conditions and prices are favorable, but contacts expect cattle prices to decline in coming months.

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

The Twelfth District economy expanded at a solid pace from mid-April through the beginning of June. Price inflation for final goods and services edged up, largely due to the pass-through of earlier increases in energy costs, and tighter labor markets led to a slight increase in upward wage pressure. District retailers and service providers reported strong demand and sales, and manufacturing activity expanded further. Demand for District agricultural and resource-related products was solid, but late-season rains damaged some crops in California. Home sales and price appreciation continued at high rates, and demand for commercial real estate improved further. District banks reported strong loan demand and good credit quality.

### **Wages and Prices**

Contacts reported an increase in inflationary pressure on net, although the pickup largely was limited to products and services for which energy costs are a significant component. Increases in oil prices from earlier this year were passed on to the final prices of various items, including transportation services and energy-intensive goods such as fertilizers and some construction materials. This in turn led to price increases in related industries; for example, prices of packaged food rose as a result of rising delivery costs. Pricing power remained modest more generally, however, with contacts citing vigorous competition from domestic and foreign producers and continued gains in production efficiency as restraining factors.

District labor markets tightened somewhat during the survey period, especially for skilled occupations such as nursing, construction trades, and various jobs in financial services.

Contacts from the financial sector reported a recent reemergence of incentive compensation, including signing bonuses to attract qualified workers. Employer costs for health insurance benefits continued to rise, exerting a restraining influence on wage increases for some businesses but reportedly being passed on to final prices in others. General labor market tightening and shortages for some skilled occupations led to increased upward pressure on wages and salaries. However, wage pressures reportedly have subsided somewhat in the manufacturing sector, and reports from various industries suggested that the pace of wage growth more generally remained in the moderate range of 2 to 4 percent.

### **Retail Trade and Services**

District retail sales grew on balance during the survey period. Sales of new and used automobiles remained at high levels overall. However, high gas prices held down relative demand for sport-utility vehicles and light trucks, and substantially more demand strength was evident for foreign than for domestic brands. Sales of smaller retail items grew significantly and inventories reportedly stabilized further.

Service providers continued to see robust demand growth. Demand for media and high-tech services strengthened, while demand growth remained vigorous for providers of food, transportation, and health-care services. The District's travel and tourism sector continued to surge; the number of domestic and international visitors rose further at key destinations such as Hawaii, increasing hotel occupancy rates and average daily room rates from already high levels.

### **Manufacturing**

Demand was solid in the manufacturing sector, although the pace of growth has slowed. Semiconductor orders and sales were strong and inventories in balance, but capacity utilization has fallen and sales prices were held down by substantial supply; ample production capacity and limited pricing power were reported for technology products in general. Makers of machine tools and industrial equipment reported that demand remained strong, though new orders slowed. Reports from a variety of industries suggest that business investment spending grew at a steady pace during the survey period. Respondents expect further increases in investment spending during the balance of this year, which will help maintain demand growth for technology products and other capital goods going forward. Conditions in the aerospace sector have improved due to a recent upturn in new orders for commercial aircraft, and defense contractors have been busy filling orders for a variety of items related to national defense. Apparel manufacturers reported little or no change in orders and good availability of raw materials.

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

Demand for District agricultural and resource-related products remained solid in mid-April through early June. Orders and sales reportedly were strong and prices were stable for cattle, commodity crops such as cotton and hay, citrus fruits, and vegetables. However, contacts reported rising input costs, particularly for fertilizers, and recent heavy rains in California's Central Valley severely damaged the crops of cherries and other tree fruits. In the energy sector, producers operated at or near full capacity in recent weeks, and drilling and distribution of natural gas continued to grow rapidly.

### **Real Estate and Construction**

Demand remained vigorous in residential real estate markets, and conditions improved further on the nonresidential side. The pace of home sales, price appreciation, and home

construction was rapid in most parts of the District, although growth reportedly slowed a bit relative to previous periods. Demand for commercial real estate strengthened further in recent weeks, with office vacancy rates and rental rates increasing slightly in some markets. Continued solid demand for new homes plus increased demand for commercial real estate kept overall construction activity at high levels, especially in Southern California, the Las Vegas area, and Hawaii.

### **Financial Institutions**

District banking contacts reported little change from the strong conditions reported in the previous survey period, with strong loan demand and good credit quality. Commercial and industrial lending activity grew further, while demand for construction, commercial real estate, and home loans remained at high levels in most areas. Credit quality in general was good across all loan categories. A very competitive environment and narrow spreads between short-term and long-term interest rates reportedly held down profit margins in the banking sector.

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