Economic activity in the Fifth Federal Reserve District expanded moderately in 2017, according to anecdotal reports and economic data compiled by the Richmond Fed. Labor markets strengthened as payrolls expanded and wage growth picked up. In fact, compared with 2016, more firms reported raising starting wages, offering sign-on bonuses, or expanding benefits packages to attract qualified workers. Fifth District manufacturers and services firms generally reported solid growth in 2017. Hurricanes Harvey and Irma hurt some businesses, but the effects were largely temporary. Real estate markets continued to improve as home prices rose and residential and commercial construction activity expanded, although builders struggled to find enough buildable lots and construction labor to meet growing demand, so inventories of homes for sale declined in many markets.

Labor Markets
Labor market conditions generally improved during the year. By December 2017, payroll employment in the Fifth District had grown 0.9 percent since the end of 2016, somewhat less than the national rate of 1.5 percent. The only two Fifth District jurisdictions to outpace national growth were South Carolina and North Carolina, where employment expanded 1.6 percent in each state. Maryland reported the slowest year-over-year growth in the District at just 0.1 percent, while employment growth in the District of Columbia (D.C.), Virginia, and West Virginia ranged from 0.5 percent to 1 percent.

In the Fifth District as a whole, the professional and business services industry led employment growth in absolute terms (37,900 jobs), while the natural resources, mining, and construction industry reported the largest percentage growth of 2.4 percent by adding 17,900 jobs. Overall job growth was constrained, however, by slow growth in the District’s two largest sectors—government and trade, transportation, and utilities—which grew 0.1 percent and 0.4 percent, respectively, and by a 0.2 percent decline in the District’s smallest sector, information.

Meanwhile, the unemployment rate in the Fifth District ended the year at 4.2 percent, which was just slightly above the national rate of 4.1 percent. In 2017, the District unemployment rate reached its lowest mark since October 2007. Since last December, jobless rates declined in every jurisdiction, with the largest improvements occurring in North Carolina and Virginia, where each rate declined 0.5 percentage points. Virginia continued to report the lowest unemployment rate in the District at just 3.6 percent in December 2017.

Anecdotes from across the Fifth District also indicated a tightening labor market in 2017 as many employers reported difficulty filling open positions. Some of the most often cited shortages were for engineers, accountants, information technology specialists, construction workers,
and truck drivers. In a survey conducted by the Richmond Fed in November 2017, employers were asked which approaches they took to find workers. The most selected answer was retaining and promoting existing employees to reduce the need for new hires, followed by increasing the wages, signing bonuses, or benefits offered to new hires. Other popular approaches were to hire less-qualified applicants and train them or to use a temporary staffing agency.

Moreover, when asked about the use of starting wages to attract new hires, nearly 74 percent of responding firms in November said they had raised starting wages for some or most job categories. By comparison, when the same survey was conducted two years ago, less than 50 percent of respondents reported raising starting wages. Existing employees were also more likely to see wages increase more than in previous years, according to the survey results.

The most recent data from the Bureau of Labor Statistics’ Quarterly Census of Employment and Wages reinforced the anecdotal evidence. The average wage across industries in the District during the four quarters ending in September 2017 was up 2.2 percent from the same period in 2016. Employees in the construction industry saw the largest average wage growth of 4.1 percent, followed by those engaged in financial services, where the average wage rose 3.5 percent. The average wage in the professional and business services industry grew 2.5 percent from the fall of 2016 to the fall of 2017.

**Business Conditions**

Manufacturing activity strengthened in 2017 and had its strongest year since 2010 by some metrics. The Richmond Fed maintains a composite manufacturing index based on its Fifth District Survey of Manufacturing Activity. It is a diffusion index, meaning that a positive reading indicates that the share of firms reporting expansion exceeds the share of firms reporting contraction. The composite index spent all of 2017 above zero, ranging from three to thirty. The reading of thirty was the highest on record, and the last time the index reached a value greater than twenty-five was in April 2010.
Anecdotal reports from manufacturers were also generally positive throughout the year. Some of the most consistently positive accounts came from manufacturers of metals, computer and electrical components, plastics, rubber, and corrugated packaging and pulp. Food manufacturers reported solid growth but faced narrow profit margins. Several manufacturers cited increased production coming as a result of investment in new equipment. However, despite consistently positive index readings for employment from the Bank’s survey, many expressed challenges finding and retaining skilled labor.

In August and September, Hurricanes Harvey and Irma had some direct and indirect effects on District manufacturers, most of which were negative. The most noted impacts were supply chain disruptions and increased prices for items such as gas, freight, lumber, and plastic resin. There were also some reports of plant and mill shutdowns, delayed delivery times and lagged payments, and decreased sales in affected locations. On the other hand, a few manufacturers saw sales and production increase as new orders were diverted to them from plants that were directly hit by the storms.

Services firms consistently reported expanding business activity in 2017, according to the Bank’s services sector survey, in which the revenues index for the sector remained above zero all year, ranging from ten to thirty. Anecdotally, some of the strongest growth was reported by transportation and hospitality services. For example, ports in Maryland and South Carolina reported record levels of cargo units shipped, while many hotels and restaurants across the District benefited from robust tourist activity.

The retail industry also strengthened in 2017, according to both anecdotes and the Richmond Fed survey, in which the index for revenues remained well above zero all year. Despite reports of intensifying competition from online retailers, many brick-and-mortar establishments experienced growth in sales, particularly for big-ticket items such as furniture, appliances, and recreation and outdoor equipment.

The survey indexes for employment in the manufacturing and services sectors were mostly consistent with the labor market data. The manufacturing index for employment
started the year off at a value of six and rose over the course of the year to end at a reading of twenty. Manufacturers generally said that strengthening demand for their products drove the need to hire. However, many also noted difficulty finding workers with the requisite skills, a problem that put upward pressure on starting wages. These reports were supported by the survey measure of manufacturing wages, which steadily rose during the year.

Likewise, the services sector measure of employment averaged seventeen during the year, which was up from an average of thirteen in 2016. In the nonretail subsector, the employment index was consistently elevated at values typically between fifteen and twenty. Meanwhile, the same index in the retail subsector, which also held above zero all year, peaked at forty in July, which was the highest reading in the survey’s twenty-five-year history. As in the manufacturing industry, the index for wages in the overall services sector trended higher in 2017, averaging twenty-four (up from twenty in 2016).

Fewer services firms were affected by the hurricanes than manufacturers, but almost all of the reported effects were negative. The most common impact was a decline in sales in the affected regions. Additionally, some services firms noted that the storms caused transportation and warehousing disruptions and delayed deliveries from suppliers.

**Real Estate**

Fifth District housing markets improved in 2017. House prices, according to CoreLogic Information Solutions, grew 4.2 percent from the previous year, which lagged the national annual growth rate of 6.6 percent. House prices in North Carolina and South Carolina rose the fastest (5.5 percent and 5.3 percent, respectively), while prices in D.C. grew the slowest (2.5 percent). Contacts also noted low inventory levels and said that desirable properties were selling quickly.

Residential construction expanded, on the whole, despite growing constraints in the availability of buildable lots, rising materials costs, and challenges finding construction workers. In several cases, the constraints drove up prices for new homes at a faster rate than for existing homes. Although multifamily construction started to slow in many markets, some areas continued to report expansion in multifamily compared with 2016. Fifth District jurisdictions issued a combined 154,511 residential building permits in 2017, which was an increase of 11.3 percent from the prior year. Single-family permits grew 12.4 percent, while multifamily permits grew 8.9 percent. Total housing starts grew slightly slower than total permits, increasing 8.7 percent in 2017.
Commercial real estate activity also expanded in 2017, particularly for industrial development and for warehousing and distribution centers. There were also some reports of strong demand for more health care space. In some markets, the demand for retail construction picked up, particularly for smaller spaces and in mixed-use developments. Office and retail leasing generally rose, and average rents reportedly moved higher.

**Banking Conditions**

Bank consolidation continued in 2017, and Fifth District banking conditions improved overall. However, net interest margins remained compressed, some banks utilized increasingly higher levels of volatile funding sources to support loan growth, and small pockets of credit-quality problems began to develop.

District banks’ earnings improved in 2017, though earnings challenges remained. The District’s median return on average assets of 0.78 percent, as of the third quarter, reached its highest level since 2007, but the District median stayed below the national median of 0.98 percent. Earnings improvements were primarily the result of lower overhead expenses with about two-thirds of District banks improving their efficiency ratios. However, small District banks continued to be less efficient compared with larger institutions, a fact that may be fueling industry consolidation. While interest rates increased over the year, District banks’ net interest margins remained flat. In addition, banks’ fourth-quarter earnings across the nation were negatively impacted by corporate tax reform. Bankers expect to benefit from the lower corporate tax rate over the long term, but the new law required many institutions to recognize one-time write-downs to their deferred tax assets in the fourth quarter.

Loan growth was solid and supported by increasing capital ratios on average. District banks’ balance sheets expanded at a median pace of 6.1 percent, slightly above the national year-over-year median growth rate of 5.8 percent. Although slower than the prior year, loan growth remained strong across all lending categories, particularly in the commercial real estate (CRE) sector. In addition, some District banks continued to maintain relatively heavy reliance on potentially volatile funding sources, which may include brokered deposits, uninsured deposits, and listing service deposits. While, on average, noncore funding levels have trended downward since the financial crisis, District levels continued to be higher than national levels.

Nonperforming loans and net losses remained low; however, credit-quality indicators deteriorated slightly in a few specific areas, such as the consumer category at large banks and in CRE portfolios at some small and midsize banks. On average, District banks’ loan loss provisions declined slightly as a percent of total expenses from a year ago.

**Conclusion**

On balance, the Fifth District economy expanded in 2017 and outpaced growth in 2016 by many metrics. Employment increased during the course of the year, and tighter labor market conditions put more pressure on firms to raise starting wages or expand benefits. Residential and commercial real estate activity picked up in 2017, although builders faced headwinds of a shortage of available lots and difficulty finding workers. In general, businesses across the District reported growing optimism throughout 2017 that extended into a positive outlook for growth in 2018.