

DISTRICT ECONOMIC OVERVIEW

BY ROBERT LACY

The Fifth District economy expanded at a somewhat quicker pace in the third quarter of 2005. Services and retail activity was particularly brisk, boosted early in the period by accelerating automobile and light truck sales. Manufacturing output rose as well, with shipments and capacity utilization at least moderately higher during the quarter. Labor markets, however, were not as upbeat: Year-over-year payroll job growth eased and the District's unemployment rate inched up during the period.

Higher energy prices were much in the news in the third quarter but did little to slow consumer spending. Retail gasoline prices rose above \$3 per gallon in the wake of Hurricane Katrina in early September, and energy analysts warned that heating bills could be exceptionally high this winter. Still, consumer spending was steadfast despite the developments in the energy sector. Retail spending heading into the holiday sales season was generally good.

Economic Growth Continues

Services businesses generally reported strong sales gains in the third quarter. Retail sales rose throughout the period, and were especially strong in July and early August as attractive price

Economic activity rose at a somewhat quicker pace in the third quarter, though growth in employment moderated.

incentives spurred automobile and light truck sales. Higher fuel prices caused a run-up in costs for airlines and trucking firms in September and prompted fuel surcharges in a variety of businesses, but demand remained relatively strong for most types of services.

Residential real estate markets continued to flourish, and home prices rose at a rapid pace in many localities in the third quarter. According to the Office of Federal Housing Enterprise Oversight, house prices in the District of Columbia, Maryland, and Virginia were more than 18 percent higher than a year ago. Price appreciation and sales growth eased in some housing markets, though. The pace of construction also slowed: The number of residential

building permits issued in Fifth District states in the third quarter was 5.8 percent higher than a year earlier, down from a 10.5 percent pace in the second quarter.

Manufacturing shipments rose in the third quarter, as did new orders and capacity utilization, albeit at a moderate pace. But District manufacturers had to cope with surging petroleum-based raw materials prices and shortages of materials originating from the hurricane-damaged Gulf Coast region in September. While materials shortages soon eased, raw materials prices escalated through November.

Moderate Job Growth

Employment growth in the Fifth District for the first three quarters of 2005 was below the pace nationwide. Third-quarter payroll employment in the District was 1.2 percent higher than a year earlier, somewhat short of the 1.7 percent pace nationwide. Across the District, employment gains continued to be centered in services industries, while manufacturing employment generally declined. In North Carolina, the District's most industrialized state, there were 8,100 fewer manufacturing jobs in the third quarter compared to a year earlier.

District Income Growth Bests Nation's

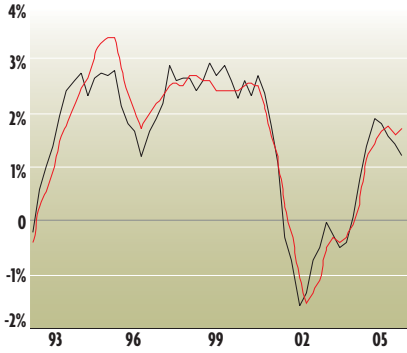
In contrast to employment growth, real personal income growth in the Fifth District continues to outpace growth nationwide. Income growth in the Fifth District was 3.3 percent above year-ago levels in the third quarter, surpassing the 2.4 percent U.S. pace. On a real per-capita basis, growth was strongest in Washington, D.C., with a year-over-year gain of 4.7 percent. Per-capita personal income in the District of Columbia was \$56,119 in the third quarter, tops in the Fifth District.

Economic Indicators

	3rd Qtr. 2005	3rd Qtr. 2004	Percent Change (Year Ago)
Nonfarm Employment (000)			
Fifth District	13,374	13,211	1.2
U.S.	133,961	131,731	1.7
Real Personal Income (\$bil)			
Fifth District	888.7	860.2	3.3
U.S.	9,176.5	8,959.5	2.4
Building Permits (000)			
Fifth District	63.8	60.3	5.8
U.S.	575.4	531.0	8.4
Unemployment Rate (%)			
Fifth District	4.9%	5.0%	
U.S.	5.0%	5.5%	

Nonfarm Employment

Change From Prior Year
First Quarter 1992 - Third Quarter 2005



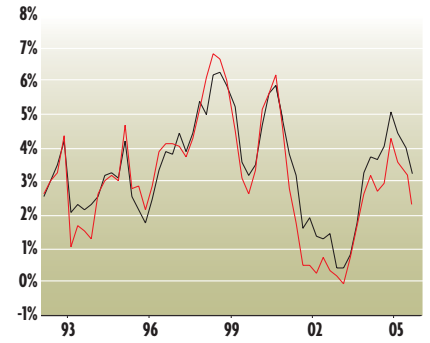
Unemployment Rate

First Quarter 1992 - Third Quarter 2005



Real Personal Income

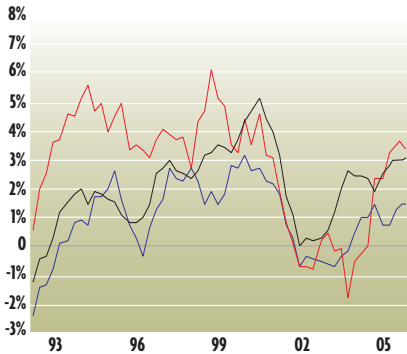
Change From Prior Year
First Quarter 1992 - Third Quarter 2005



— Fifth District — United States

Nonfarm Employment Metropolitan Areas

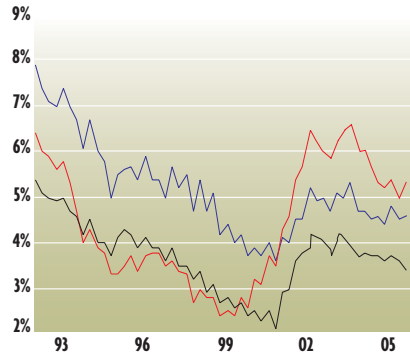
Change From Prior Year
First Quarter 1992 - Third Quarter 2005



— Charlotte — Baltimore — Washington

Unemployment Rate Metropolitan Areas

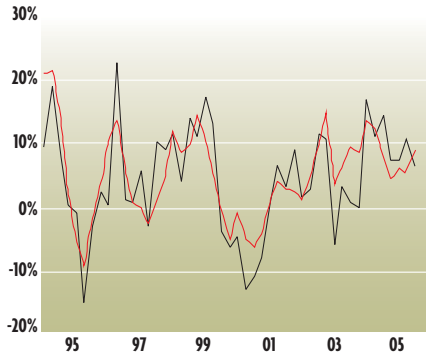
First Quarter 1992 - Third Quarter 2005



— Charlotte — Baltimore — Washington

Building Permits

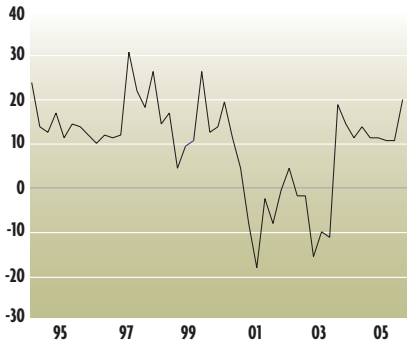
Change From Prior Year
First Quarter 1994 - Third Quarter 2005



— Fifth District — United States

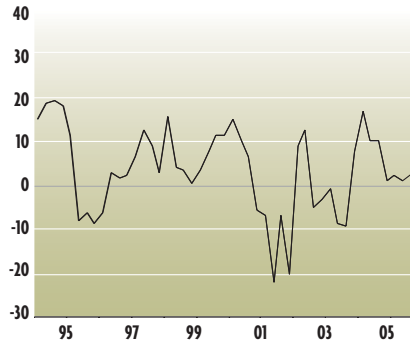
FRB — Richmond Services Revenues Index

First Quarter 1994 - Third Quarter 2005



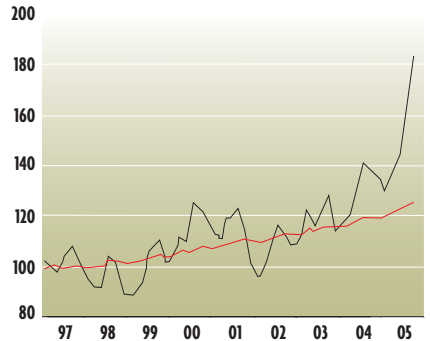
FRB — Richmond Manufacturing Composite Index

First Quarter 1994 - Third Quarter 2005



Washington D.C. — Baltimore Metro Area Consumer Price Index

January 1997 - September 2005



— Energy — All Items

NOTES:

1) FRB-Richmond survey indexes are diffusion indexes representing the percentage of responding firms reporting increase minus the percentage reporting decrease. The manufacturing composite index is a weighted average of the shipments, new orders, and employment indexes.
2) Metropolitan area data, building permits, and CPI are not seasonally adjusted (nsa); all other series are seasonally adjusted.

SOURCES:

Income: Bureau of Economic Analysis/Haver Analytics
Unemployment rate: LAUS Program, Bureau of Labor Statistics, U.S. Department of Labor, <http://stats.bls.gov>.
Employment: CES Survey, Bureau of Labor Statistics, U.S. Department of Labor, <http://stats.bls.gov>.
Building permits: U.S. Census Bureau, <http://www.census.gov>.

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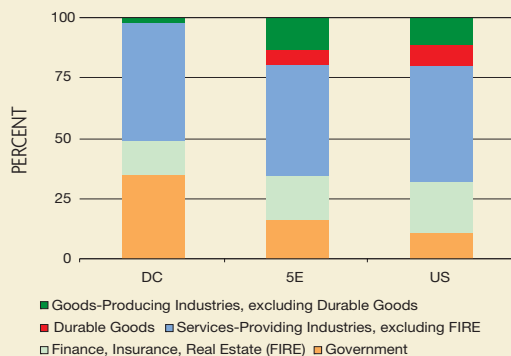
STATE ECONOMIC CONDITIONS

BY ANDREA HOLMES

District of Columbia

According to the recently released report on real gross state product (GSP) for 2004, the District of Columbia's economy expanded second fastest among Fifth District states. But the 2004 performance has not been repeated as strongly this year. While 2005 economic activity has expanded, third-quarter indicators were generally flat. Payroll and household financial conditions in the District of Columbia were little changed from the second quarter, and growth in the residential real estate markets expanded at a slower pace.

DC Sector Contribution to 2004 GSP



NOTE: Durable goods industries contribute only 0.2 percent of the District of Columbia's GSP, and as such, are not readily visible in the above chart.
SOURCE: Bureau of Economic Analysis

The latest estimates from the Bureau of Labor Statistics (BLS) survey of business establishments reported that third-quarter job numbers contracted 0.1 percent in the District of Columbia. Losses at education and health services, financial activities, and trade, transportation, and utilities establishments outweighed job gains in other services-providing sectors. Payroll activity on the smaller, goods-producing side of the economy also moderated somewhat. Construction jobs backed off 1.1 percent in the third quarter, perhaps reflecting softer demand for new housing.

In line with fewer construction jobs, District of Columbia third-quarter permit authorizations (sometimes viewed as an indicator of future activity) were also well below the year-ago level. Likewise, sales of previously owned homes contracted at a quicker pace for the third straight period. Rapid home price acceleration in the District of Columbia has likely contributed to the slowdown in home sales. The District of Columbia recorded a 21.5 percent jump in house prices in the third quarter — the largest increase districtwide.

The moderation recorded in the District of Columbia's housing markets does not appear to stem from a weakening of household conditions — third-quarter indicators of household

financials remained generally on track. Personal income expanded 0.3 percent, marking the second-strongest growth rate districtwide. The majority of the increase hailed from the government sector, with government earnings accounting for more than 45 percent of the third-quarter total.

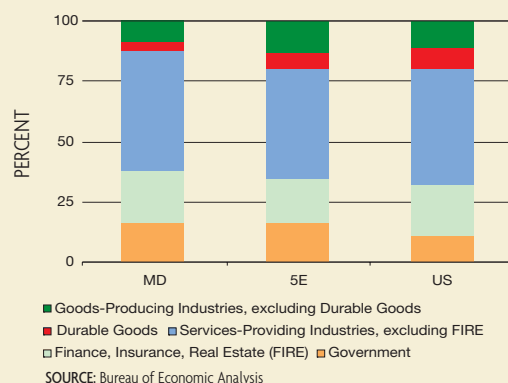
The importance of the government sector to the District of Columbia's economy was apparent in the recent measures of GSP. According to the U.S. Bureau of Economic Analysis (BEA), the government's contribution to 2004 economic growth in the District of Columbia amounted to nearly 35 percent.

Maryland

Double-digit growth in real estate activity and professional services were key factors in driving Maryland's GSP up 4.8 percent in 2004 and have helped pave the way for solid growth so far in 2005. In the latest readings, economic activity continued to gain ground in the third quarter. The most recent reports suggest that employment activity and household conditions in the state continued to improve, though growth in the residential real estate market moved ahead at a slower clip.

Maryland businesses boosted payrolls by 2.0 percent in the third quarter — the largest percentage increase recorded districtwide. Nearly all industry sectors tacked on jobs, with professional and business services and government establishments adding the most. The only sectors that didn't see a rise in employment were leisure and hospitality and manufacturing, where payrolls were trimmed by 0.3 percent and 2.2 percent, respectively.

MD Sector Contribution to 2004 GSP



SOURCE: Bureau of Economic Analysis

In line with rising payrolls, earnings rose in almost all of Maryland's industry sectors in the third quarter, boosting total personal income in the state. Compared to a year ago, third-quarter personal income expanded 3.4 percent, outpacing the nationwide gain of 2.4 percent.

The improving tone of the labor market was also reflected in Maryland's jobless rate. Large gains in the labor force in the third quarter held the jobless rate at 4.3 percent. By comparison, the national rate of unemployment stood at 5.0 percent.

Consistent with the nationwide trend, Maryland's real estate market advanced at a slower pace in the third quarter. Compared to the second quarter, new permit applications were fewer and existing home sales moved forward at a slower pace. Even with the decline in sales, however, the median price of an existing home was 19.3 percent higher in the third quarter than a year ago, marking the fifth-fastest increase nationwide.

Real estate-related activities are a vital part of the Maryland economy. As shown in the chart, output generated by finance, insurance, and real estate enterprises contributed nearly 22 percent to total 2004 GSP, a larger share than recorded in any other District jurisdiction.



North Carolina

Against the backdrop of a 4.4 percent increase in state economic output in 2004, North Carolina's economy continued to make headway through the third quarter of 2005. The labor and real estate markets advanced at a quicker pace, and nearly all indicators of household financial conditions improved.

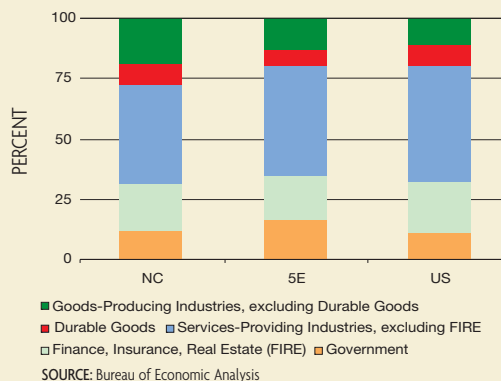
According to the BLS establishment survey, business hiring in North Carolina advanced by 14,600 jobs in the third quarter, the largest net gain districtwide. The professional and business services sector added the majority of new jobs, while the manufacturing sector trimmed the most — the 2.7 percent reduction in payrolls marked the largest quarterly loss in two years.

Despite continued job losses in the manufacturing sector, North Carolina's economy remains most dependent on non-durable manufactured goods among District states, with that sector accounting for 19 percent of 2004 GSP. Expansion in the sector has been sluggish though, contributing only one-tenth to total GSP growth in 2004.

In contrast, strong expansion on North Carolina's services side of the economy has helped keep household employment conditions bright. In the third quarter, the BLS household survey continued to suggest a generally upbeat tone. Though the jobless rate rose 0.4 percentage point to 5.6 percent — well above the national and districtwide rates — much of the gain was spurred by a 36,567 person surge in the labor force, the largest quarterly gain since early 2001.

Personal income is another telling measure of household financial conditions. Compared to a year ago, third-quarter personal income expanded 2.7 percent in North Carolina, just above the national growth rate of 2.4 percent.

NC Sector Contribution to 2004 GSP



Rising personal incomes and more moderate home price acceleration have led to sustained growth in North Carolina's residential real estate markets. Third-quarter existing home sales in North Carolina were 11.7 percent higher compared to year-ago levels and the number of new building permits issued expanded 6.9 percent over same period.

North Carolina's housing market has been buoyed by more moderate home price escalation in recent years than in other District states. The most recent data from the Office of Federal Housing Oversight reported that a median-priced home in North Carolina was only 6.9 percent more expensive than it was a year earlier. As such, the state ranked last districtwide and 37th nationwide in terms of annual home price acceleration.



South Carolina

South Carolina ranked 28th nationwide in terms of GSP growth in 2004. Despite the comparatively soft reading, however, the 2004 estimate marked the fourth straight year that the state's economic growth rate strengthened. Likewise, after getting off to a relatively slow start in 2005, economic activity in South Carolina has steadily gained momentum over the year. In the third quarter, labor market and conditions firmed further — and unlike activity in a number of District states — the housing market continued to advance steadily.

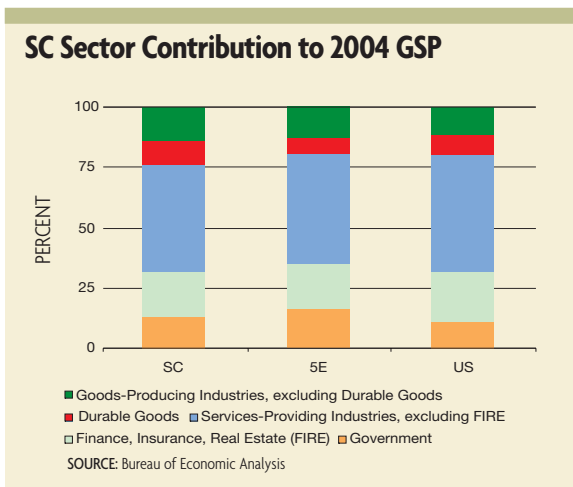
South Carolina payrolls rose 0.4 percent in the third quarter, a turnaround from the 0.7 percent contraction recorded a quarter earlier. On the services side of the economy, job growth was recorded in all sectors except government, which posted a modest loss. In contrast, all goods-producing sectors (natural resources and mining, construction, and manufacturing) saw employment declines. Though goods production has declined as a share of total economic output, it still plays a pivotal role in South

Carolina's economy — accounting for more than a quarter of the state's 2004 GSP of \$124 billion.

Outside of job growth at South Carolina businesses, indicators of household employment in South Carolina also perked up. The third-quarter jobless rate inched lower, dropping 0.1 percentage point to 6.3 percent — the lowest rate since late 2002.

In contrast to the turnaround in payroll and household employment conditions, measures of personal income in South Carolina softened in the third quarter. Personal income fell 0.1 percent compared to a quarter earlier, the second-weakest reading among District jurisdictions.

More positively though, the residential real estate market continued to gain ground in the third quarter, outpacing activity in most other District states. Third-quarter building permits were 23.5 percent higher over the year, and existing home sales posted an 18.1 percent gain, the strongest increase

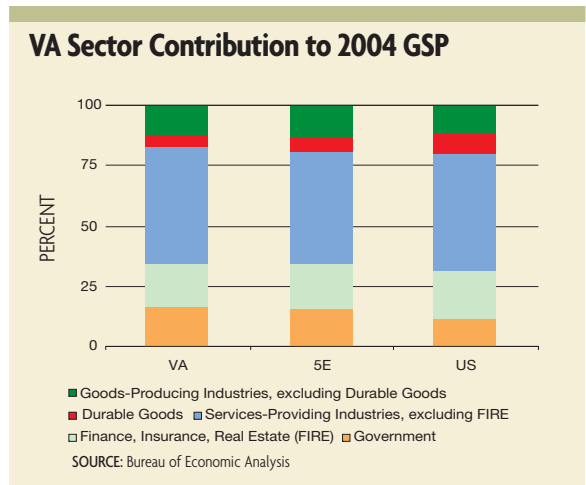


districtwide. The persistence of strong home sales growth could reflect the relatively slower appreciation of South Carolina's housing stock — the third-quarter 11.1 percent jump remained below the districtwide increase of 15.7 percent.

Virginia

In the third quarter, the BEA reported that the value of all goods and services produced in Virginia last year reached \$302 billion — the largest economy among District jurisdictions. Moreover, economic growth in Virginia outstripped that of all other District states in 2004 and ranked third nationally. With the groundwork already laid, the employment situation and financial conditions at Virginia households forged ahead in the third quarter. Activity decelerated in the real estate markets though, perhaps signaling a return to a more sustainable level.

Compared to the second quarter, Virginia businesses boosted payrolls by 1.6 percent, or 14,267 jobs, in the third



quarter. The bulk of the employment gains occurred on the services side of the economy, which according to the BEA, generated nearly 70 percent of total GSP in 2004.

The employment situation at Virginia households also remained upbeat — the jobless rate held firm at 3.6 percent, the lowest rate districtwide and more than a full percentage point below the national rate of 5.0 percent.

Robust economic growth and better employment prospects have helped boost incomes at Virginia households. In the third quarter, personal income expanded 0.4 percent, the highest growth rate districtwide.

In real estate markets, Virginia households and businesses trimmed activity from the elevated levels seen recently, as did businesses. At the household level, third-quarter sales of existing homes backed off 1.5 percent compared to a quarter earlier. And on the business front, applications for new building permits declined sharply. More telling, both measures came in below levels recorded a year ago, signaling the possibility that the real estate market is near its peak.

The trailing off of sales from their peak comes on the heels of a rapid acceleration of home prices in Virginia. According to the Office of Federal Housing Oversight, the median-priced home in Virginia was 18.7 percent above year-ago levels in the third quarter, ranking seventh nationally in terms of annual home price acceleration. Signs of a cooling market, however, were evident in this measure as well. Compared to the second quarter, home prices advanced at a slower pace, marking the first period of moderation in a year.

West Virginia

The U.S. Department of Commerce recently reported that West Virginia had the 43rd fastest-growing economy in 2004. Manufacturing remained the largest private sector segment of the economy, contributing 11.4 percent

to GSP. This sector, however, contributed the least to economic growth — contracting 0.5 percent in 2004 and dragging overall growth lower. Fast-forward to the third quarter of 2005 and the state seemed unable to shake off 2004's lackluster performance. Economic conditions in West Virginia appear to have retreated further, with third-quarter indicators of employment and household financial conditions weakening. Not all news was downbeat, though. Real estate activity, sustained by some of the lowest home prices in the nation, continued to move forward.

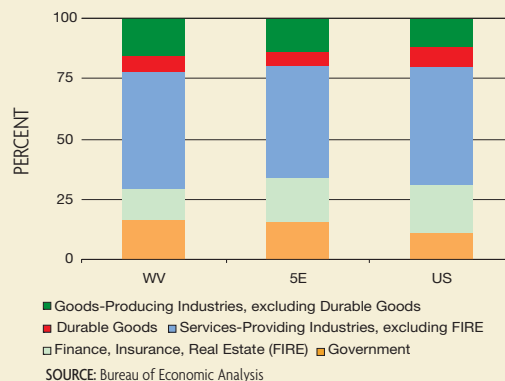
According to the BLS establishment survey, payroll employment retreated 0.7 percent in West Virginia during the third quarter, the weakest reading among District jurisdictions. Nearly all sectors trimmed jobs, with the largest losses recorded in manufacturing and leisure and hospitality.

The less upbeat tone was mirrored in the BLS survey of household employment. West Virginia's jobless rate moved 0.8 percentage point higher in the third quarter to 5.6 percent, coming in well above both the national and Fifth District averages.

The decrease in jobs coupled with an increase in unemployment partly explains West Virginia's somewhat muted income measures. Compared to a year ago, personal income expanded only 2.6 percent in the third quarter, the slowest increase districtwide.

Despite modest personal income growth, third-quarter home sales and new permit authorizations remained well above year-ago levels. Still though, the most recent data from

WV Sector Contribution to 2004 GSP



the Office of Federal Housing Oversight reported third-quarter home price appreciation of only 10.4 percent in West Virginia, the second-lowest growth rate districtwide.

Limited home price acceleration during the most recent boom may help insulate West Virginia homeowners should the market self-adjust. In addition, the state would be further cushioned as real estate-related business activities play a comparatively small role in West Virginia's overall economy. As shown in the chart, output generated by finance, insurance, and real estate enterprises contributed only 13 percent to total 2004 GSP, the smallest share recorded districtwide.

Behind the Numbers: Do Surveys Matter?

People who watch the U.S. economy rely on a number of indicators to help them understand how things are going. The problem with some of these indicators — especially regional ones like Gross State Products and manufacturing employment — is the lag time between the periods they measure and when they are released. That makes the Federal Reserve Bank of Richmond's manufacturing and retailing surveys, published on a monthly basis, especially valuable. The surveys provide information on business activity that might not have already shown up in other economic data. The Richmond reports are closely watched in large part because the composition of the Fifth District economy — with a good mix of manufacturing and services business — is similar to that of the broader, national economy.

The Richmond's manufacturing survey is distributed to about 200 manufacturing managers in the Fifth District during the second week of each month. Managers are asked whether their shipments, new orders, and employment increased, decreased, or didn't change over the past month. Other sections ask about inventory levels and price trends. The results are published in the form of a diffusion index, in

which "0" represents the level of business activity the previous month. Positive numbers, then, suggest growth and negative readings suggest that the level of activity decreased.

But how useful are these surveys in helping economic policymakers? After all, if the survey results are driven chiefly by factors that don't tell us much about where we are in the business cycle's two- to five-year fluctuations in output, employment, and income, then policymakers don't learn much that is helpful in making decisions about monetary policy.

So do the surveys matter? That's the question that Richmond Fed economists Raymond Owens and Pierre-Daniel Sarte try to sort out in a recent paper in the Federal Reserve Bank of Richmond's *Economic Quarterly*.

Their analysis demonstrates that most of the survey index's movements are directly tied to the overall business cycle, not extraneous factors like seasonal swings or long-term trends. That means when business managers respond to the Richmond manufacturing survey, they are essentially telling policymakers something about where the country is in the business cycle. For policymakers, that kind of information is priceless.

— DOUG CAMPBELL

State Data, Q3:05

	DC	MD	NC	SC	VA	WV
Nonfarm Employment (000)	681.7	2,576.0	3,894.9	1,832.9	3,644.4	743.4
Q/Q Percent Change	-0.1	2.0	1.5	0.4	1.6	-0.7
Y/Y Percent Change	1.6	2.1	1.1	0.1	1.3	0.9
Manufacturing Employment (000)	2.5	138.5	573.5	263.8	298.6	62.0
Q/Q Percent Change	5.4	-2.2	-2.7	-0.7	0.3	-6.2
Y/Y Percent Change	1.3	-3.3	-1.4	-2.0	-0.4	-1.2
Professional/Business Services Employment (000)	147.2	391.0	450.1	188.6	588.0	59.2
Q/Q Percent Change	0.9	2.9	6.7	3.0	0.2	6.3
Y/Y Percent Change	2.7	4.5	4.1	-2.5	1.0	1.7
Government Employment (000)	231.9	467.8	660.3	331.5	658.1	143.4
Q/Q Percent Change	2.9	2.5	2.3	-1.3	1.7	-1.1
Y/Y Percent Change	0.9	0.7	-0.1	0.0	0.9	-0.1
Civilian Labor Force (000)	299.6	2,944.3	4,342.8	2,075.6	3,935.0	797.8
Q/Q Percent Change	-0.7	2.3	3.4	1.5	3.0	2.5
Y/Y Percent Change	0.6	2.1	1.8	1.2	2.9	1.2
Unemployment Rate (%)	6.4	4.3	5.6	6.3	3.6	5.6
Q2:05	7.7	4.3	5.2	6.4	3.6	4.8
Q3:04	8.4	4.3	5.4	6.9	3.7	5.4
Personal Income (\$bil)	27.6	210.0	238.1	108.4	260.4	44.2
Q/Q Percent Change	0.3	0.3	0.1	-0.1	0.4	-0.2
Y/Y Percent Change	3.4	3.4	2.7	2.8	4.2	2.6
Building Permits	182	7,628	25,794	13,361	15,301	1,529
Q/Q Percent Change	-99.8	-48.3	-13.6	-18.3	-41.2	-4.1
Y/Y Percent Change	-45.7	2.6	6.9	23.5	-5.1	4.3
House Price Index (1980=100)	571.2	468.5	302.2	289.0	427.9	222.1
Q/Q Percent Change	21.5	17.4	7.9	11.1	18.2	10.4
Y/Y Percent Change	20.5	19.3	6.9	8.5	18.7	10.7
Sales of Existing Housing Units (000)	10.0	139.7	253.6	120.6	184.9	39.4
Q/Q Percent Change	-21.9	0.4	32.5	7.2	-1.5	-3.7
Y/Y Percent Change	2.0	-3.0	11.7	18.1	-3.6	5.1

NOTES:

Nonfarm Payroll Employment, thousands of jobs, seasonally adjusted (SA) except in MSA's; Bureau of Labor Statistics (BLS)/Haver Analytics, Manufacturing Employment, thousands of jobs, SA in all but DC and SC; BLS/Haver Analytics, Professional/Business Services Employment, thousands of jobs, SA in all but SC; BLS/Haver Analytics, Government Employment, thousands of jobs, SA; BLS/Haver Analytics, Civilian Labor Force, thousands of persons, SA; BLS/Haver Analytics, Unemployment Rate, percent, SA except in MSA's; BLS/Haver Analytics, Personal Income, bil.chn. 20005, BEA/Haver Analytics, Building Permits, number of permits, NSA; U.S. Census Bureau/Haver Analytics, Sales of Existing Housing Units, thousands of units, SA; National Association of Realtors®

Metropolitan Area Data, Q3:05

	Washington, DC MSA	Baltimore, MD MSA	Charlotte, NC MSA
Nonfarm Employment (000)	2,938.3	1,288.4	797.1
Q/Q Percent Change	0.8	1.4	-0.2
Y/Y Percent Change	2.9	1.4	3.1
Unemployment Rate (%)	3.4	4.6	5.3
Q2:05	3.6	4.5	5.0
Q3:04	3.7	4.6	5.3
Building Permits	7,822	2,490	6,094
Q/Q Percent Change	-80.1	-20.3	21.5
Y/Y Percent Change	-19.9	-0.9	3.6
	Raleigh, NC MSA	Charleston, SC MSA	Columbia, SC MSA
Nonfarm Employment (000)	268.8	281.6	345.1
Q/Q Percent Change	-0.4	1.2	-2.5
Y/Y Percent Change	0.6	2.5	0.6
Unemployment Rate (%)	4.5	5.2	5.5
Q2:05	4.3	4.8	5.3
Q3:04	4.2	5.5	5.9
Building Permits	1,186	2,618	1,846
Q/Q Percent Change	-12.7	9.5	-38.9
Y/Y Percent Change	-17.4	16.5	4.6
	Norfolk, VA MSA	Richmond, VA MSA	Charleston, WV MSA
Nonfarm Employment (000)	763.7	617.2	148.7
Q/Q Percent Change	2.0	-0.7	-4.9
Y/Y Percent Change	1.1	2.8	-0.1
Unemployment Rate (%)	4.2	3.8	5.0
Q2:05	4.1	3.7	4.9
Q3:04	4.1	3.9	4.5
Building Permits	2,582	2,666	82
Q/Q Percent Change	3.2	43.2	-79.6
Y/Y Percent Change	8.0	10.2	-16.3

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