



January 14, 2004

## Summary

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### Summary

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Prepared at the Federal Reserve Bank of Kansas City and based on information collected before January 6, 2004. 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.

Reports from Federal Reserve Districts suggest that the nation's economy has continued to improve since the last survey. The strongest report came from the San Francisco district, which said its economy expanded soundly. Most other districts also gave quite favorable reports, saying their economies improved, strengthened further, or grew at a moderate pace. However, Cleveland, Chicago, and Dallas reported only slow or modest growth, and St. Louis said conditions were mixed. Retailers and manufacturers reported that prices were generally steady despite increases for raw materials.

Holiday retail sales were generally positive across the country, and auto sales either improved or held steady in most districts. Manufacturing activity increased in nearly all districts, and New York, Philadelphia, and Kansas City noted some growth in factory employment. Housing remained strong, particularly in the Boston and San Francisco districts. Commercial real estate was still weak, although a few districts reported signs of firming. Travel and tourism activity increased considerably, and gains were reported in most other service industries as well. Bank loan demand was flat or slightly lower, with credit quality generally unchanged. Energy and agricultural activity was steady in most districts, although the appearance of mad cow disease created considerable uncertainty in the cattle industry.

Along with the increase in overall economic activity, many districts reported modest improvements in labor markets. These improvements took the form of reduced layoffs or modestly increased hiring, although new hiring was still quite minimal in several districts and most types of workers remained easy to recruit. Health care and other employee benefit costs continued to rise. However, with labor markets still slack, wage pressures remained generally subdued. Retail prices were generally flat, with some districts reporting less discounting of holiday retail prices than in previous years. Manufacturers in most districts also held their selling prices steady, despite substantial increases in the prices of some raw materials such as steel and natural gas.

### Consumer Spending

Reports on holiday retail sales were generally upbeat across the country, particularly for sales during the last two weeks of 2003. San Francisco gave the strongest report, saying robust sales led to considerable year-over-year gains. Holiday sales were also quite solid in the Boston, Philadelphia, St. Louis, and Kansas City districts. Most other districts reported more modest year-over-year sales growth, although some of these districts noted an

improvement in sales at the end of December. Cleveland, on the other hand, said retailers were generally disappointed by sluggish sales during the holidays. All districts reporting on store inventories said stock levels were generally in good shape for 2004, and all districts reporting on expectations for future retail sales anticipate continued improvement in the months ahead.

Looking across product categories, sales of high-end items were characterized as especially strong in several districts, including New York, Philadelphia, Atlanta, and San Francisco. Likewise, electronics and home furnishings sold well in many districts. On the other hand, sales of apparel were reported to be soft in the Philadelphia and Cleveland districts, and San Francisco noted heavy discounting at lower-priced apparel stores. Indeed, sales at discount stores in general were reported to have been below plan in several districts, including New York, Cleveland, and Kansas City.

Reports on auto sales were also generally positive, with most districts reporting either steady or improving sales at the end of the year. Cleveland, St. Louis, and Minneapolis characterized new vehicle sales as "strong" or "solid" in December, although St. Louis reported that sales of used cars were not as robust as sales of new cars. Richmond, Chicago, and San Francisco all noted some improvement in vehicle sales from previous months, while Atlanta, Kansas City, and Dallas said sales were mixed or flat. Philadelphia noted that a seasonal slowing in auto sales resulted in a buildup of inventories, and dealers in the Cleveland district were worried about their ability to sell all of their 2003 models. Otherwise, though, districts reporting expectations for auto sales were generally optimistic about 2004.

### **Manufacturing**

Nearly all districts reported increases in manufacturing activity in December, and several districts noted that factory employment had begun to edge up as well. Chicago reported broad-based improvement across manufacturing industries, and Dallas and San Francisco said factory activity increased in a variety of sectors. Philadelphia, Richmond, and Kansas City noted strong orders in December, and Boston said several firms had been "pleasantly surprised" by recent increases in orders. Factory employment was reported to have posted modest overall gains in the New York, Philadelphia, and Kansas City districts, and factory jobs also reportedly picked up in select industries or for select occupations in the Boston, Richmond, and San Francisco districts.

Looking across industries, primary metal manufacturing was said to be improving in the Philadelphia, Cleveland, and Richmond districts, and production of various high-tech goods continued to rebound in the Boston, Dallas, and San Francisco districts due to increased capital spending by customers. Several districts also noted increases in the production of industrial machinery, building materials, and transportation equipment. On the negative side, St. Louis reported layoffs in the biotechnology, food, and tobacco industries. Petrochemical producers suffered from overcapacity in the Dallas district and continued to lay off workers in the Atlanta district. In addition, producers of paper goods in the Boston and Philadelphia districts reported some weakness.

Manufacturers across the country generally expect factory conditions to continue to improve in the months ahead, and several districts noted that capital spending in 2004 will be somewhat higher than in 2003. Much of the increased spending will go towards replacement of outdated IT and other capital equipment, but both Chicago and Kansas City reported a few firms plan plant expansions as well. Exceptions to the optimistic outlook

included textile producers in the Boston and Richmond districts, who continue to suffer from excess capacity.

### **Real Estate and Construction**

Residential real estate activity remained robust, with home sales and new construction reported to be strong in most districts. In the Boston district, home sales in Massachusetts continued to rise at double-digit rates, while housing activity in other parts of the district returned to more normal levels following boom conditions during the last two years. In the San Francisco district, home sales increased and home price appreciation remained solid. In most other districts, home sales and single-family homebuilding were reported to be holding steady at high levels. The only districts reporting some slowdown in overall housing activity were Chicago and Dallas. Contacts in the Chicago district said some easing was inevitable given the previous boom, but Dallas reported that high inventories of existing homes were becoming a concern. Both Boston and Kansas City reported that the high-end market was weaker than the entry-level market, although tentative signs of a turnaround in high-end construction were noted in Kansas City. The multifamily market remained weak in the few districts reporting on this sector, the only bright spot being a modest recovery in apartment rents in New York.

Commercial real estate activity remained weak, although there were signs of improvement in a few districts. In most districts, commercial real estate markets and nonresidential construction were described as soft with little improvement expected in the near term. Commercial builders in the Cleveland district viewed 2003 as a weak year and did not expect conditions to improve for at least the next six months. In the Chicago district, vacancy rates remained elevated in most segments of the market, and contacts saw no indication of a firming in demand at the end of the year. On a more positive note, however, a few districts reported either a pickup in activity or improvement in expectations for the future. For example, Atlanta reported that commercial construction activity was still generally weak but that leasing activity continued to improve. In the Dallas district, the office market remained soft, but contacts were increasingly optimistic that the worst was behind them. The strongest report came from the Richmond district, where contacts were highly encouraged by a pickup in leasing activity late in the year.

### **Tourism and Services**

Travel and tourism activity improved substantially. Boston, Richmond, Minneapolis, Kansas City and San Francisco all reported a surge in visitors to ski resorts due to very good snow conditions, while Atlanta noted increased optimism about winter tourism in Florida and New Orleans. Boston also reported a positive outlook for international bookings due to the lower dollar and promotional airfares. Demand for hotel rooms in New York remained strong, as brisk leisure travel activity more than compensated for a continued slump in business travel. In other reports on business travel, Atlanta observed a modest increase in convention bookings, while Boston noted increased spending on corporate entertaining and higher bookings for corporate meetings in 2004.

Activity in other service industries generally expanded as well. Several districts reported increased demand for freight transport services. For example, Cleveland observed busy trucking activity serving retailers, Dallas reported increased rail shipments of lumber due to strength in construction, and San Francisco noted that exports and holiday imports kept several seaports operating at capacity. Looking at other sectors, Dallas reported robust growth in legal services, Philadelphia noted improved demand at marketing firms, and New York cited unusually brisk hiring for office jobs. Boston reported little change in overall demand for insurance, with slightly higher sales of long-term care products but lower

revenue from large-property insurance. On a negative note, Richmond indicated lackluster activity at several business support and technical firms.

### **Banking**

Overall demand for bank loans either remained unchanged or declined somewhat in most districts. Home mortgage lending continued to fall due mainly to lower refinancing activity. Banks in the Chicago district reported that new mortgage originations were also slowing somewhat, although such lending remained fairly strong. Demand for consumer loans fell somewhat in the New York and St. Louis districts and rose in the Philadelphia and Kansas City districts. Business loan demand increased in the Philadelphia, Richmond, and St. Louis districts but held steady or weakened in other districts. Banks in the Richmond district attributed the increased demand for business loans to the stronger economy and were optimistic about lending prospects for 2004. In the Chicago and San Francisco districts, banks reported more inquiries about lending terms from small businesses, even though overall business lending remained flat.

Credit quality and lending standards were little changed in most districts. Credit quality was described as stable in the Philadelphia district, although some banks reported higher defaults on consumer loans. Banks in the New York district reported fewer delinquencies in all loan categories except business loans. In the Chicago district, business loan quality improved, but home mortgage loan quality eroded slightly. The only changes in credit standards were in the New York district, where they were tightened slightly for non-mortgage loans, and in the Chicago district, where some large banks were said to be loosening standards on business loans in an effort to boost lending.

### **Natural Resources and Agriculture**

Activity in natural resource industries generally held steady. Ore mining in the Minneapolis district continued at a strong pace, as some mines produced near capacity while other, previously shut, mines reopened. Energy activity in the Dallas district was little changed, but contacts noted continuing excess capacity in the oil services and machinery industry. Oil and gas drilling in the Kansas City district remained unchanged at levels considerably higher than a year ago, while Minneapolis reported a decrease in both oil and natural gas exploration. Looking ahead, natural gas producers in the Kansas City district plan increased capital spending in anticipation of continued strong production, but contacts in both the Kansas City and Dallas districts expect some decline in oil production in coming months.

While most districts reported steady conditions in the farm economy, the appearance of mad cow disease created substantial uncertainty in the cattle industry. Farm incomes were supported in the Chicago district by strong hog production and by rising corn and soybean prices, while incomes in the Kansas City district were maintained by high soybean prices and still-elevated cattle prices. In the San Francisco district, farmers benefited from strong holiday sales of cut flowers and Christmas trees. Crop conditions in the Atlanta and Dallas districts were reported as stable. However, farmers in some parts of the Minneapolis and Kansas City districts continued to suffer from drought, and Richmond reported harvest and planting delays due to excessive precipitation. The emergence of a case of mad cow disease in Washington state resulted in a great deal of uncertainty for cattle ranchers. Contacts in several districts noted substantial declines in cattle prices due to foreign bans on U.S. beef exports. The uncertainty was causing ranchers in the Kansas City and Dallas districts to take a wait-and-see approach toward herd adjustments. San Francisco, on the other hand, reported that the appearance of mad cow disease was boosting sales of range-raised beef.

## Labor Markets, Wages, and Prices

Most districts reported modest improvements in labor markets in December. San Francisco noted a pickup in hiring, Minneapolis reported more hiring announcements than layoff announcements, and Kansas City said layoffs dropped considerably. Likewise, demand for temp workers increased in the Philadelphia and Richmond districts, and Chicago said the seasonal decrease in temp employment this year was less than in the previous two years. On the other hand, hiring was said to be quite minimal in several districts. Cleveland, for example, noted that most firms still do not plan to increase payrolls in the near future. In addition, while hiring improved somewhat in the Atlanta district, firms generally remained reluctant to add full-time staff. Both Kansas City and Dallas noted some pickup in demand for high-tech workers, although such workers were still easily recruited in the Kansas City district and some types of high-tech and telecom work in the Dallas district continued to be outsourced overseas. Acute labor shortages were generally reported only for select health care fields, with some hospitals in the Atlanta district recruiting overseas to fill open nursing positions.

Wage pressures generally remained subdued throughout the nation, but most districts continued to report greater upward pressure on health care and other employee benefit costs. Chicago, Kansas City and San Francisco described wage increases as "weak" or "modest" and Boston stated that wages were mostly stable. Exceptions were reported in the Dallas district, with wages subject to downward pressure in the airline industry but upward pressure in certain occupations such as skilled mechanics. Meanwhile, districts consistently reported that employee benefit costs continued to increase. San Francisco said that the improving job market was making it harder to shift increases in health care premiums to workers, resulting in slightly higher growth of total compensation.

Most districts reported little change in final goods prices, but costs of some raw materials rose noticeably. Retail prices were generally stable. Atlanta, Kansas City, Dallas, and San Francisco all reported less discounting of holiday retail prices than in previous years, although a few other districts said holiday discounts were similar to last year. In manufacturing, the most widely cited increase in raw materials costs was for steel. Contacts in the Cleveland district said steel producers were raising prices to cover the increased cost of their own inputs, such as scrap and iron ore, and that steel prices were likely to continue rising through the first quarter. Price increases were also reported in some districts for copper and aluminum. In the Boston district, prices of lumber and plywood were reported to have fallen back somewhat from the highs reached in the third quarter, but contacts in other districts said these prices were still well above year-ago levels. In most districts, manufacturing firms were reported to still be having difficulty passing input costs on to their customers. In the Dallas district, petrochemical producers held their selling prices steady in the face of sharply rising natural gas prices, and trucking firms kept their rates unchanged despite higher fuel costs. The only signs of a change in pricing power were in the New York and Kansas City districts, where some firming in selling prices was reported.

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