CONFIDENTIAL (FR)

CURRENT ECONOMIC COMMENT BY DISTRICT

Prepared for the
Federal Open Market Committee
by the Staff

June 12, 1974

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SUMMARY*

"Moderate economic recovery" capsules the views of most Red Book reports this month. Inflation and materials shortages once again seem to be major items of concern. While some reports expect a subsiding of inflationary pressures toward year's end, others expect these pressures to remain severe throughout the year. Current views on materials shortages also vary. Some Districts indicate a loosening of basic materials supplies, while other reports indicate continued shortages. Residential construction remains depressed, with strikes of construction trades making matters even worse in several Districts. Capital spending plans remain strong, though some downward revisions of capital expenditures have apparently taken place because of high interest rates, materials shortages, and the cyclical downturn in the economy. Inventory building as an inflationary hedge or because of the fear of shortages has been limited and scattered. Business loan demand remains at high levels despite high interest rates. However, there were some reports of slight reductions in demand; and lending is reported to be more selective now. Delinquencies on most types of loans are up. Consumer spending is beginning to show some life, with a renewed interest in larger autos as one area of strength. Heavy rains may cut into expected bumper crops in some Districts.

The first quarter slide in economic activity has apparently bottomed out, and a moderate economic expansion is now under way in most Districts. Philadelphia reports that the first quarter slide has ended. Cleveland, St. Louis, and Minneapolis note that economic activity is beginning to pick up and should continue to do so throughout the rest of this year. San Francisco, however, does not expect much improvement until the third quarter.

*Prepared by the Federal Reserve Bank of Atlanta.

A number of Districts emphasize the growing concern over inflation. Philadelphia sees inflation as the sore spot in its economy, with price increases on manufactured items and raw materials continuing throughout the year. This view was echoed by Atlanta, St. Louis, and San Francisco, while Cleveland expects some abatement in price increases by the fourth quarter.

Though supply problems continue to exist, some easing is beginning to be noticed. Boston, Richmond, and Chicago note some loosening in supplies. However, other Districts indicate continued difficulties and longer lead times in obtaining plastics, basic petrochemicals, steel, and electrical goods.

Residential construction remains universally weak in all Districts. In Minneapolis, San Francisco, and St. Louis, strikes in the construction trades have depressed this sector even further. The Administration's new housing program is expected to have only a slight impact on residential construction. New York describes the program's probable impact as a "cushion" to a further decline in residential construction rather than a stimulus.

Capital spending continues to be the major area of strength, but some retrenchment in these spending plans may now be taking place. Boston reports some postponing of capital spending because of anticipated declines in interest rates. Reports from New York indicate "some cooling of enthusiasm" regarding expansion programs. Materials shortages are curtailing capital spending in the San Francisco District.

Inventory building because of materials scarcities is not as widespread as earlier reports indicated. Atlanta and New York note that high financing costs may be inhibiting inventory investment in many areas. Cleveland also finds some signs of inventory investment abating, and responses to Richmond's survey of manufacturers suggests that inventories may be higher than desired.

Views are mixed on the effects of record-high interest rates on loan demand. Philadelphia, Cleveland, Minneapolis, Dallas, and San Francisco indicate little letup in loan demand. However, Boston, Richmond, St. Louis, and Kansas City note a slight reduction, particularly in demand for business loans. A pickup of deposit growth at commercial banks was also observed in several Districts. Richmond's survey of large District banks, as well as information from other Districts, reveals that firmer credit standards are being applied to loan requests. Several Districts also indicate that an increase in loan delinquencies and a rise in bankruptcies are a matter of growing concern.

Consumer spending in most Districts is beginning to perk up. St. Louis and Kansas City indicate that appliances are selling well. Tourist activity is on the upswing and is expected to remain so through the summer months in the Atlanta and Minneapolis Districts. Several Districts note a pickup in the sale of larger-sized cars. Minneapolis suggests, however, that consumer resistance to higher car prices may be responsible for a more recent drop in sales.

Agricultural prospects appear mixed. Reports from a number of Districts confirm the decline in livestock prices. San Francisco's agricultural prospects are expected to be excellent throughout the District. Rain and bad weather have affected crop plantings and prospects for crop yields in the Chicago, St. Louis, Kansas City, and Atlanta Districts.

FIRST DISTRICT - BOSTON

Our directors reported that the business situation remains pretty strong, with the cost of money the major business problem. The high cost of money has led both to a noticeable slowing in business loans, as firms trim inventory accumulation and large outflows from thrift institutions.

The directors felt that businessmen are more concerned with the cost of money than with the state of business. Machine tool manufacturers have varied reports. Some report continued strength in capital goods areas, while others note a dip in hand tool orders. Automotive suppliers still have some weakness. Generally, the consumer sector is weak, although there has been some pickup in recreational vehicle sales.

While manufacturers noted a lessening in supply problems, they have focused on money problems. One director from a management consulting firm discussed his difficulties in collecting payments, even from major utilities. Another director notes that with floor-planning loan rates at 18 percent, dealers had to cut back on inventories. Our Bank directors report that borrowers are postponing capital spending plans because they anticipate a decline in interest rates or are borrowing less than they normally would because manufacturers and wholesalers are cutting down on inventories. As a result, one bank director reported that his outstanding commercial loans dipped below year-ago levels. A business director from Connecticut also cited high interest rates as a cause in delaying capital spending but felt that the expectation of a coming slowdown in business had led to a slowing in expansion plans anyway. He also noted that there were quite a few companies, especially small businesses and seasonal borrowers such as clothing manufacturers and the tobacco industry, which were being pushed to the wall by high interest rates.

On the wage scene, our directors generally noted that nonunion employees have been given some form of cost-of-living increase to compensate for inflation. In some cases, this has also been extended to retired employees on pensions. One director commented on a recent Wall Street Journal article that was critical of the Fed for lending to the Franklin National Bank at a discount rate which was below market rates. He cited the 4-percent loans to Lockheed to argue that it was common practice to lend to an ailing firm at below market rates. Only two of our academic respondents, Professors Tobin and Eckstein, were available for comment this month. Professor Tobin reiterated his position that monetary policy is too tight and that the Fed funds rate should be eased down to 8 percent over the next two months. He feels it is unimportant to quibble over whether the present policy will produce a N.B.E.R. recession or not, since we know it will raise the unemployment rate to 6 percent. He feels there should be some redefining of recessions to tie them more closely to the behavior of unemployment. Tobin emphasized that it is not within the Fed's power to deescalate the wage-price spiral in the short term. The cost of doing this through macroeconomic policy by keeping unemployment rates up is far too high. Instead, Tobin argues that inflation should be attacked through an incomes policy. Professor Eckstein strongly agreed that monetary policy is too tight and the Fed funds rate cannot be held at 11 1/2 percent for very long without bringing down the financial system. If the Fed funds rate is 11 percent in July, Eckstein predicts massive outflows from thrift institutions as market forces enable the public to enter the 11-percent money. He notes that when the financial system cracks, it always cracks in unexpected places, so we won't be prepared.

A major question the Fed should be asking itself, according to Eckstein, is how much the Fed can accomplish in slowing inflation by this policy. Eckstein agrees with Tobin that the Fed is being unrealistic if it thinks monetary policy can do much to stop a wage-price spiral by a growth recession if the rest of the government does nothing. Eckstein believes that a 1958 type recession will slow inflation but that it will terminate the independence of the Fed because the whole political spectrum is not that conservative. Real wages have been declining. Eckstein argues that the Fed should not try to defeat the labor movement's attempts to regain their wage position because it will create economic chaos, since the Fed cannot compensate for all the sins of government. Eckstein believes the Open Market Committee should lower the Fed funds rate below 11 percent at this meeting and below 10 percent at the next, with an 8-percent rate as its target. Money supply targets should be at least 7-percent growth rates. Eckstein agrees that the Fed cannot have a real money supply target, but he also believes the Fed cannot ignore the real money supply without killing the patient.

SECOND DISTRICT - NEW YORK

According to Second District directors and other business leaders who were recently contacted, there has as yet been little easing of materials shortages and capacity limitations. The business capital spending outlook on balance remains strong, but the District residential construction picture appears bleak. High financing costs, as well as shortages, may be inhibiting inventory investment in some sectors, and little evidence of excessive inventory accumulation was noted.

Most respondents perceived little or no indications that shortages and capacity limitations were easing up. Among others, the president of a multinational chemical corporation reported continuous shortages and capacity limitations in his industry, while a senior official of a nationwide chain of department stores noted that many items were still not available. An official of a large paper firm reported that while his firm might be obtaining an adequate supply of raw materials, the production capacity situation in the paper industry was still very tight and his firm was behind in shipping its products to its customers. The president of a large electrical equipment distributing firm, on the basis of conversations with his firm's suppliers, saw no easing as yet in the supply and capacity picture. On the other hand, the chairman of a large New York City bank reported that some basic materials have become more easily available since price controls were removed, and the president of a nonferrous metals product manufacturing concern reported some softening in the copper and brass markets, which he associated with the current weakness in the auto and construction industries. Both respondents, however, noted that many materials shortages still persist.

Responses to a question about business capital spending were mixed, but most of the respondents felt that financial market conditions had not yet caused firms to cancel or cut back their capital spending plans, at least in dollar amounts. The New York City banker mentioned above thus stated that he was not aware of any reduced capital spending plans, while the retailer reported that his firm was upgrading its capital spending plans to take into consideration the rise in construction costs. The official of the paper firm reported that his firm, and probably the paper industry in general, was embarking on a three- to five-year expansion program involving significantly higher outlays than had been expected in recent years, while the president of a diversified financial institution characterized the demand for capital as "still good." On the other hand, the president of a large New York City bank stated that some of his bank's business customers reported that their firms were cutting their expansion programs in physical terms although not in dollar terms, and the chairman of another large New York-based financial institution noted "some cooling of enthusiasm" regarding expansion programs. The president of the nonferrous metal products concern stated that his firms had become "definitely more conservative" with respect to capital expenditures in the light of current financial market conditions; and while another director was not aware of reduced capital spending plans solely as a result of financial market conditions, he felt this could become a factor for some electric utilities.

There were suggestions that current high, short-term interest rates may be, as stated by a New York City banker, acting as a "restraining influence" on firms' inventory policies. The president of the nonferrous metal products firm reported that the high cost of carrying inventories had induced his firm to institute tighter inventory controls. The great majority of the respondents commenting on the inventory situation felt that there has been no excessive inventory accumulation as yet. Among others, the president of an electric equipment distributing firm reported that his firm's sales had risen more rapidly than its inventories, and he felt this was also true for many of its customers. Other respondents, including the retailer and the paper company official, cited the shortage of some items as another factor inhibiting inventory accumulation.

Second District residential construction remains weak. The president of a large New York City savings bank cited the continued loss of deposits by thrift institutions to higher-yielding Treasury securities and, in his view even more significant, the high cost of construction with new housing not selling well. An official of a savings bank trade association reported that savings banks in the New York City area had continued to suffer net outflows of deposits in May and that the savings and loan associations had probably undergone a similar experience. He saw no evidence of a turnaround in residential construction at this moment. The respondents in general felt that the Administration's new housing program was likely to have little effect on the housing industry. In the view of the savings bank association official, it might be a "cushion" to a further decline in residential construction rather than a stimulus.

THIRD DISTRICT - PHILADELPHIA

Economic activity in the Third District continues to show that the downward slide of the first quarter has ended. Production activity is stable for the second consecutive month, and manufacturers report that this level of activity is expected to hold steady through the end of the year. Employment too remains stable. Retail sales continue to show surprising strength, as do spending plans for plant and equipment. Inflationary pressure is the sore spot in the regional economy, as area businessmen expect both the prices they receive and the prices they pay for manufacturing goods and raw materials to continue rising during the next two quarters.

Bankers reported that while total loan demand remains at mid-April levels in Philadelphia, business borrowing has advanced slightly. Moreover, disintermediation is not currently a problem with Philadelphia banks, as they continue to post deposit gains.

Manufacturers in the Third District, responding to this month's business outlook survey, report a general leveling in the regional economy, both in June and six months in the future. Currently, almost three-fourths of area manufacturing executives are experiencing no change in their new orders, shipments, and unfilled orders. Last month's extended outlook reported an expected increase in business activity by November. However, it now appears that some manufacturers have revised their expectations, with nearly half reporting no change in these key indicators up through the end of the year.

Employment opportunities also reflect this stabilizing trend in the regional economy. While just one in ten employers expects to decrease the number of his employees or reduce the average workweek in the next two quarters, only one in ten expects to increase the number of employees and one out of twenty-five anticipates lengthening the average workweek. Yet, as the size of the work force continues to grow, we are likely to see some increase in the level of manufacturing unemployment in the Third District in the months ahead.

Manufacturers report little change in inventory stocks this month. And, with raw material prices on the rise, only a third of the executives expect to boost the level of their investment in raw materials by the end of the year. However, though somewhat more cautious than last month, respondents still remain optimistic about their plans for increases in expenditures on plant and equipment in the next six months.

Philadelphia department stores are reporting steady sales in summer apparel. However, fall lines will start coming out in July, and retailers are pessimistic about the effect that higher prices will have on consumer spending. With the garment strike presumably settled, retailers anticipate only short-term problems such as delayed deliveries. However, if the strike is extended over a considerable period, serious shortages would have occurred.

The outlook for prices in manufacturing is also reported gloomy. Respondents are still increasing their own prices on finished goods and are, in turn, paying higher prices for raw materials. Though other indicators in the regional economy appear to be leveled off, manufacturers report expectations of an increased push on prices until at least the end of the year. Over three-fourths expect to receive and to pay higher prices six months out.

Reflecting this leveling in business activity in the region, Philadelphia banks report the growth rate for total loans holding steady since mid-April, although business borrowing has advanced slightly. Surveys of Philadelphia banks indicate some increase in REIT and utility borrowing, as these industries are being pushed out of financial markets. Philadelphia bankers are continuing to realize deposit growth, and reliance on Federal funds has decreased sharply. Regional banks report a continued rise in total loans and a growth rate for deposits at somewhat less than April's levels.

FOURTH DISTRICT - CLEVELAND

Manufacturing activity in the District appears to have strengthened in May for the second successive month, and bank loan demand showed little change. At a meeting held in this Bank on June 7, thirty economists (primarily from major industrial firms and banks in the District) generally agreed that the economy was beginning to recover and indicated they expected continued strengthening in output during the balance of this year, accompanied by abatement of price increases by the fourth quarter. In the discussions, considerable emphasis was placed on the crosscurrents of strengths and weaknesses in the economy, distortions caused by inflation and price controls, uncertainties regarding the impact of monetary policy, and the response of labor to the past rate of inflation. According to a source in the savings and loan industry, deposits about equaled withdrawals in May, following sizable outflows in deposits during April.

Preliminary returns from our monthly manufacturers' survey suggest further improvement in new orders, shipments, backlogs, and employment in May. Inventory investment shows some sign of abating. The percentage of firms reporting price increases was the highest in the 10 years of this survey.

Major banks in the District report little change in business loan demand in recent weeks. Two Cleveland banks reported what they consider a temporary slackening in demand, with the passing of earlier shifts of borrowers out of commercial paper. Another has experienced some unexpected demand because two large industrial customers postponed capital market financing. Construction loans present problems to four of six large banks contacted. These problems involve requests for maturity extensions and increased loan amounts and reflect cost overruns, materials shortages, and, in some cases, delayed or canceled takeouts of permanent financing by insurance companies.

The business economists project a 1-percent growth rate for real GNP during the second quarter, followed by gains of 2.4 percent and 4.0 percent in the third and fourth quarters. Over the same period, the GNP deflator is projected to rise at annual rates of 8.2 percent, 7.4 percent, and 6.0 percent, respectively. The unemployment rate is expected to drift upward to 5.75 percent by year-end. The projected economic recovery is based largely on improvement in the consumer sector and strength in capital spending. Some economists raised questions as to how much of the recent pickup in retail sales was due to tax refunds and whether real income of consumers would recover in the near term. The sentiment of the group was that there would be an acceleration of nominal wage increases during the second half; moderating inflation would, therefore, result in real income rising enough to sustain a recovery. New car sales, in particular, are expected to remain on an upward course. The median forecast of 10 economists whose firms depend heavily on the auto market places this year's domestic new car sales at 8.1 million units and imports at 1.6 million units. Fleet purchases of new cars, which have been below normal during the last two to three quarters, are expected to bolster sales in the months ahead. Automotive economists also see evidence of a recovery in sales of recreational vehicles.

On the matter of capital spending, there was widespread agreement among the roundtable economists that the secular need for increased capacity overwhelms normal cyclical forces. According to the economists, capital spending ordinarily would be expected to weaken under conditions of tight money and prospects for declining corporate profits. Some economists noted that much business investment is planned on the prediction that long-term interest rates will be lower and demand stronger toward year-end. The prevailing view was that, despite high interest rates, the pressures for capital spending are on the upside. Basic process industries, such as steel, petroleum, and chemicals, are considered to have the best liquidity positions for financing their investments. On the other hand, utilities appear to be reassessing their spending plans in view of the dramatic shift in their cost structure and uncertainties regarding growth prospects. Automotive economists hold the view that sales of heavy trucks will begin to decline later this year, partly because of increased costs associated with antiskid devices. It was reported that capacity limitations and shortages have held down the recent physical volume of capital outlays. A shortage of casting capacity, for example, has contributed to a short supply of engines, which has in turn held down shipments of trucks. Steel shortages also have inhibited shipments of numerous capital goods.

Several steel industry economists said steel shortages will become even worse during the second half. Shipments have been above industry capacity for two years. With mill inventories depleted and the deferment of needed maintenance, the steel industry's ability to ship in the second half will be less than in the first half. Moreover, if there is a coal strike in December, the steel industry will be forced to shut down because coal and coke supplies are very tight. Little relief in the steel situation is expected during 1975. A steel economist expressed the opinion that the economy's potential growth rate next year could be restricted by the limited availability of steel.

According to the roundtable group, sectors of near-term weakness in the economy include housing, the net export balance, and inventory investment. An economist with a Federal Home Loan Bank reported that the savings and loan industry would have sufficient funds to ensure 1.6 million housing starts for 1974 if there is no massive disintermediation. At any rate, housing is projected to begin recovering very slowly beginning in the fourth quarter. The net export balance is expected to decline for the remainder of the year. Inventory investment, following a pickup in the second quarter, is expected to ease slightly in the second half. It was noted that there has been an unknown degree of inventory speculation. As prices of certain raw materials come down, inventory building should subside.

An economist with a major agricultural corporation discussed the outlook for grains and meat. Wheat and feed grain crops are expected to be sufficiently abundant to cause some price declines between now and next fall. Prices of livestock and hogs, however, are expected to rise 10 to 15 percent at wholesale, while broilers could rise by one-third.

FIFTH DISTRICT - RICHMOND

Some easing of demand pressures on the Fifth District economy is suggested in our latest survey. Reports from manufacturers indicate a decline in new orders, the second successive such reduction; and shipments are apparently being maintained at recent levels only through a working down of order backlogs. Also, for the first time since late last summer, the diffusion of manufacturing responses suggests that inventories may be higher than desired. Trade respondents report recent increases in the dollar volume of retail sales, although sales of big ticket items apparently lack buoyancy. Residential building continues in a sharp slump, and recent reports indicate that the current stringent credit conditions are also dampening nonresidential construction. Reports of materials shortages continue to crop up but rather less frequently than in earlier surveys. A large majority of survey respondents report increases in employee compensation and in prices paid and received. In a special survey of a sample of large District banks, respondents in every state except North Carolina and Maryland report some easing of business loan demands.

The orders picture at District manufacturers appears considerably less robust than earlier in the year. In our latest survey, 20 of 48 manufacturing respondents report declines in new orders against only 8 reporting increases, and 21 indicate a reduction in backlogs against 6 reporting increases. New orders are apparently holding up well in electrical equipment and supplies and in primary metals but have slipped in most other major District industries and especially in textiles and furniture. The diffusion of manufacturing responses suggests some further recent accumulation of both materials and finished inventories, but it may be noteworthy that of the 48 respondents 16 evaluate their inventories as too high while 11 characterize them as too low. This is the first time in the last ten surveys that reports of excessive inventories outnumber reports of deficiencies. The diffusion of responses also suggests small reductions in both employment and hours worked in manufacturing.

A large majority of retailers in our survey report recent gains in the dollar volume of retail sales, but just as many report declines in sales of big ticket items as report increases. Also, the balance of responses suggests a decline in retail inventories and a reduction in employment. Some respondents cite recent wage increases and a tight labor market as factors holding down retail employment.

Construction continues in a sharp slump, with residential building reported as having declined substantially further in recent weeks. Reports of shortages of building materials persist, but high building costs and unusually high interest rates on construction loans of all kinds appear to be the chief factors in the slowdown. Prospective home buyers are reported to be unable to find mortgage financing or reluctant to borrow at prevailing mortgage rates. Nonbank intermediaries have cut back significantly on their mortgage lending, and, in only one state, are commercial banks reported to be supplying such funds in any quantity.

Large banks in the District indicate that they are applying firmer credit standards in reviewing loan requests, with new customers being subjected to particularly close scrutiny. Most bankers are apparently increasingly reluctant to make loans with long maturities and are shying away from business term loans and real estate loans. Most also continue to note a step-up in the activity of large national accounts, relating this to the increasing difficulty of financing in the commercial paper market. Nevertheless, the surveyed banks in every state except North Carolina and Maryland express the view that business loan demand may be easing from the recent feverish pace. Only the North Carolina banks entertain any firm expectation of continued increases in business loan demand.

Businessmen in our survey are apparently somewhat less optimistic about the six months' outlook for the national economy than they were a month ago. The number expecting national conditions to worsen increased moderately in the latest survey and now exceeds by a considerable margin the number expecting some improvement. But, interestingly, in evaluating the outlook for their respective industries, more expect improvement than declines. A large number of manufacturers continue to consider their current capacity too small relative to expected sales, and several feel that current expansion plans should be enlarged.

SIXTH DISTRICT - ATLANTA

Inflation continues to be of uppermost importance to most businessmen contacted this month. Most expressed concern over the current fiscal policy stance but wholeheartedly urged continuation of a restricted current credit policy as a means of restraining inflation. Material shortages continue to plague the District economy; labor shortages were also apparent in some areas. Again, several announcements of capital spending plans were noted, some by foreign-based firms. Tourist activity has picked up, but auto sales remain substantially below year-ago levels. Some businessmen have indicated limited inventory building from fear of continued material shortages. The much publicized fertilizer shortage is apparently not as critical as earlier expected. The new minimum wage has had only scattered distorting impact on District labor markets so far.

Reports from many District businessmen confirm the heightened concern over inflation. The term "double digit inflation" is creeping into many businessmen's conversations. They see little relief in sight, with the continued shortages of materials and upcoming wage negotiations putting upward pressure on costs the remainder of this year. These businessmen see "double digit inflation" leading to a growing lack of confidence in our entire financial system. In order to combat inflation and restore confidence, there seems to be universal agreement that a restrictive monetary policy is needed for some time to come.

There seems to be little relief in sight from the materials shortages which have been affecting many businesses and manufacturers. Several construction contractors have noticed a loosening in building material supplies. However, District manufacturers continue to report difficulty and longer waiting periods in obtaining all metals and metal products, paper, and plastic pipe. As reported earlier, some layoffs and increases in unemployment have occurred in parts of the District. However, shortages of skilled workers and craftsmen exist in many areas. Economic activity along the Alabama and Mississippi Gulf Coast is booming. Several new plant announcements have recently been reported. The most recent is a new $40-million cement-manufacturing facility south of Mobile, Alabama; it will be financed through revenue bonds. Tourist activity continues to pick up. The Disney World and the Daytona Beach areas are booming. Tourist and convention business is still strong in New Orleans, particularly at the downtown hotels. Auto sales, though improving recently, remain well below year-ago levels in the District. The regional office of one of the big three auto manufacturers indicates that for the first ten days of May, auto sales in the Southeast are 24 percent below the year-ago period. One brighter note is that truck sales, particularly small trucks, are down only fractionally from a year ago. A report from an importer of Japanese-made cars indicates that unit sales in the Southeast are behind the comparable period last year; but the spokesman said that sales would be ahead if there were cars to sell. Apparently a dock strike in Japan kept them from getting cars to fill all the orders. Several announcements have been made of foreign manufacturers locating plants in the Sixth District; ten such announcements have been made so far this year. In April alone, four were made, 20 percent of the U. S. total.

A survey of several District manufacturers indicates some hedged inventory building has taken place in this region, particularly in steel, paper, fuel oil, and critical machine parts. However, in many cases, manufacturers were simply unable to build inventories because of shortages. Several manufacturers did mention longer lead times in placing orders today. In response to why they were attempting to build inventories, all manufacturers agreed that fear of continued shortages rather than expectations of higher prices down the road was the major reason. There was universal agreement that shortages would continue for some time to come. They also indicated that building inventories strictly for an inflationary hedge would not be profitable today because of the high cost of carrying inventories (i.e., high interest rates on inventory loans). Some indication was given of turning to commercial banks for short-term financing of this inventory building.

Summer supplies do appear adequate for fuel supplies to utilities. The power companies which burn natural gas had supplies curtailed somewhat last winter because the Federal Power Commission has diverted gas to the Northeast, but no problems are expected this summer other than rising fuel prices. One electric utility which had been burning 100 percent natural gas now has the capability of burning 40 percent fuel oil, thus being better prepared for fuel emergencies. A Louisiana power company which had been a 100-percent natural gas user has announced plans to build a coal-fired plant using low sulphur western coal scheduled for completion in 1978 and costing $150 million. Coal-burning utilities in the Southeast are finding it difficult to build inventories. A severe coal miners' strike is expected, but inventories cannot be increased because of the closing of some mines. Coal supplies are apparently adequate for current consumption needs, however.

Although there is a tight market for fertilizer, supplies appear adequate. Earlier reports indicate that fertilizer shortages might precipitate switching some corn acreage into soybeans, but this does not seem to be happening in the District. Heavy rains in the Mississippi Delta area are delaying some cotton plantings. Because of a lack of cold weather this winter, the Georgia peach crop may be as much as 25 percent below last year's.

A telephone survey of employment security offices in the District indicates only scattered and very limited distortions from the increased minimum wage enacted on May 1. Most analysts report it was too early to tell what the total effect would be. However, some domestic workers, yardmen, porters, janitors, and farm laborers are apparently out of work because of the increase in the minimum wage. One report from a large Georgia city indicated that some women have quit their jobs rather than pay the higher cost of employing domestics.

SEVENTH DISTRICT - CHICAGO

The economic picture in the Seventh District is mixed, both among industries and localities. Capital goods producers continue to push output against limits imposed by availability of resources. Nonresidential construction remains generally strong. On the other hand, output of autos, small trucks, and recreational vehicles remains well below the levels of last year, and there is scant hope for an early revival in the severely depressed housing industry. Shortages of material remain widespread, although easing in supplies is reported in some sectors. Inflation is a constant sore point with almost everyone. Announced increases in wages and salaries are running in the 9- to 12-percent range and some are higher. Prospects for the corn crops, so optimistic in early May, have been seriously altered by heavy rains.

There is no longer any serious concern that fuel shortages will hold back activities in the next several months. A question of the availability of power supplies has developed, however, because of difficulties with the operation and construction of nuclear plants in Michigan and Illinois.

A great contrast exists in the Seventh District between Michigan, where insured unemployment is at the highest rate since 1961, and Iowa, where labor shortages "run the gamut." The situation in Michigan should improve relatively in the summer. Auto output is scheduled at a third quarter record, except for 1973. (Hopes have faded for any significant improvement in auto sales until 1975 models come on the market.) In Illinois and Wisconsin, insured unemployment is above the year-ago level but well below the rates of 1971 or 1972. Strongly influenced by demand for auto components, Indiana is in an intermediate position.

Announced increases in wages are substantial, as pressures mount to offset two-digit inflation. The "revelation" that the auto workers' gain last fall was valued at 11.6 percent has set a mark for other bargainers. Nonunion employees of the nation's largest airline (headquartered in Chicago) will get increases totaling 11 percent this year. A number of municipalities have granted "across-the-board" increases of 9 percent. Union supermarket clerks in Detroit obtained a 14-percent boost in May to $5 per hour. Demands are being enforced by strikes, many of short duration, in various sectors.

The District's capital goods producers, without exception so far as we can determine, are going all out to try to contain mounting backlogs. Many have modified their methods of accepting and booking orders to hold down the "water" in their backlogs and to get scarce equipment direct to customers. Several producers of equipment for farming, construction, and mining have announced large, new expansion programs of their own in recent weeks. Along with producers of machine tools, these firms, increasingly, look upon demand for their products as basically strong through 1980 or beyond.

The end of price controls on April 30 probably loosened supplies of some raw materials and components, as market forces were allowed to operate more freely. Because of adjustments of production schedules to higher profits lines during the control period, however, the process will take some time. Steel is now the most commonly mentioned item in short supply and substitutes are seldom possible. Output will be down in the third quarter, and imports are available only in limited amounts and at extremely high prices. Castings and forgings frequently are cited as bottlenecks, partly because some shops have been shut down in recent years. Most nonferrous metals, many chemicals, and paper remain on the typical shortage list. Cement capacity is said to be down because plants have been taken out of production for environmental reasons and for needed maintenance.

District housing experts do not expect any large benefits from the Administration's proposals to inject funds into the mortgage market. This is partly because of specified restrictions on the mortgages to be financed and partly because it is believed that a substantial portion of the funds would be diverted to other markets. Savings outflows continue at S&L's, and loan commitments have been at very low levels. Pressures to lift the 8-percent usury ceiling in Illinois have not been sufficient to date. Chicago S&L's are reported to be charging fees of 7 or 8 percent on new loans, with interest rates at 7.5 percent. Assuming an average loan life of 8 to 12 years, effective rates on such loans can be 9 percent or more.

Extremely wet weather in the corn belt in the past four weeks has restricted field work and has left water standing in fields already planted. Corn plantings, which had been well advanced in early May, are now only equal to last year's slow pace. Soybean plantings also are far behind their normal schedule. Continuing heavy rains in recent days may have caused some farmers to switch acreage to soybeans. Yields on corn already planted will be reduced, partly because of hampered weed control. Heavier-than-expected marketings cf cattle and hogs suggest that the number of animals on feed, especially hogs, had been underestimated. Stocks of meat in cold storage are very large. Lower wholesale meat prices have been accompanied by sharp declines in cheese prices, much to the dismay of the State of Wisconsin.

EIGHTH DISTRICT - ST. LOUIS

Economic activity in the Eighth Federal Reserve District has continued moderately upward in recent weeks. Retail sales have increased on a seasonally adjusted basis; and manufacturing activity, with the exception of automobiles, is generally at full capacity. Construction is at a standstill in St. Louis as a result of a strike, and residential construction has slowed throughout the District. Total employment is down slightly, but the unemployment rate is relatively low. Inflation and supply shortages remain a major concern of businessmen in the area. Bankers report that growth of loan demand has slowed and bankruptcies are up. Farming conditions are mixed. Livestock feeders are losing money, but most crop prices remain at profitable levels for producers.

Retail sales in the Eighth Federal Reserve District have generally continued upward in recent weeks. A representative of a major St. Louis department store reported that sales of all major lines except women's fashions had increased on a seasonally adjusted basis. Sales increases were also reported by businessmen in Arkansas, Mississippi, and West Tennessee; however, some slowdown in the rate of consumer purchases may have occurred in Louisville. Sales of appliances, however, were reported to be holding up surprisingly well in Louisville and St. Louis, in view of the decline in housing construction.

Manufacturing activity in the District is continuing at full capacity with the exception of automobile production. Two of the major automobile assembly plants in the St. Louis area have laid off one shift each, or roughly one-third of their work force, and a third plant has laid off a few workers. Most other manufacturers report that backlogs of orders still exist for most types of capital equipment. There has been some slowing in demand for certain types of appliances, primarily of the gas burning type; however, the decline was more than offset by gains in other appliance sales. Demand for home freezers is especially high, reflecting the larger number of home gardens in urban areas and plans for freezing the vegetable crop. With the slower rate of home building and automobile output, demand for plastics and fibers is down; and even though raw material sources for such products, largely petroleum, have become scarcer, the upward price pressures have been less than expected.

Residential construction has slowed in most of the District, and, in St. Louis, it has come to a standstill as a result of a strike by the construction workers. Single-family housing is also reported to be at a standstill in Memphis and falling off in Louisville and Little Rock.

Commercial construction is spotty. It has been halted by the strike in St. Louis, but in other parts of the District it varies from slow to moderate, being retarded in some communities by shortages of equipment and materials.

The latest available data indicate a slight decrease in total employment in most Eighth District states compared to the beginning of the year. The unemployment rate was unchanged in April from the previous month and remains below the national average of 5 percent. In Mississippi, Missouri, and Tennessee, the unemployment rate is below 4 percent. In the Eighth District SMSA's, it ranged from 2.7 percent in Little Rock to 5.7 percent in St. Louis.

Inflation remains a major concern of Eighth District businessmen. Suppliers of many items are reported to be wary of quoting a price of future delivery. A major manufacturer in Louisville reported that materials costs have skyrocketed, largely reflecting shortages in steel and plastics. A Louisville brewery representative reported that increased costs of supplies and inability to raise selling prices were major problems. He reported a 72-percent increase in the cost of barley malt since the first of the year and an 82-percent increase in the cost of corn since last year. A Little Rock businessman reported that roofing asphalt has risen 56 percent this year and that benzene has risen tenfold since 1973. Complaints of high fertilizer prices continue. An Arkansas businessman viewed with alarm our decision-making process which allows the money supply to increase while inflation is accelerating.

There were a number of comments, however, to the effect that the rate of inflation may be subsiding. A St. Louis businessman reported that a number of formerly scarce items were becoming more available and that people are beginning to back away from panic buying. An oil industry representative reported that the price of crude oil has fallen back from winter levels and that more gasoline has come on the market in the last two weeks. He expects a stabilization of gasoline prices this summer.

Loan demand at major Eighth District financial centers may have reached a plateau. Total loans at the major banks showed very little change from April to May. Demand deposits have continued sharply upward in recent weeks, but other deposits have remained fairly stable.

The savings and loan associations reported large inflows of funds; however, outflows were often greater than the inflows, as the 7 1/2-percent certificates are not being renewed. Holders of these certificates are investing their savings in higher-yielding assets. Bankers reported that bankruptcies and delinquencies are the highest in several years. Some bankers associate this problem with the labor stoppages, but delinquencies also seem to be a problem in areas that have not experienced severe strikes.

The agricultural situation varies from good to bad, depending on the type of farm production involved. All feeders of animals have lost money in recent weeks. Beef cattle feeders have probably suffered the worst losses. Some are believed to have lost as much as $100 per cow.

Crop planting got off to an excellent start in most of the District, but, in recent weeks, planting has been slowed because of excessive rainfall, especially in Illinois and Indiana. If farmers are further delayed in planting corn, they will be forced to switch to faster-maturing, lower-yielding varieties or to some other crop. Most crop prices remain favorable to producers, providing incentive for sizable output increases over the 1973 crop.

NINTH DISTRICT - MINNEAPOLIS

According to directors' responses, the combination of scarce mortgage funds and high interest rates has seriously curbed District home building; the directors do not believe recent government efforts to stimulate this industry will significantly benefit the District. So far, high interest rates have not reduced loan demand at District commercial banks, and retail sales have been quite strong. Several directors expect business to remain good this summer, but others are less optimistic. District automobile sales have held up quite well, and the outlook for this summer's tourist business is quite optimistic. Directors indicated that it's still difficult to get farm machinery, but demand may ease later this year or in 1975. Our latest quarterly industrial expectations survey indicates that District manufacturing activity should expand through the rest of 1974.

Directors commented that recent increases in interest rates and a lack of mortgage funds have slowed District home building. A Montana director said that his area's home building had come to a "grinding halt," and a Minneapolis-St. Paul area banker indicated that there are signs of accelerating weakness in the home building industry. Three directors reported no shortage of mortgage funds, but one of them felt that lenders were being more selective in granting home loans. The directors stated that the recent $10.3-billion Federal program to bolster the housing industry would not significantly affect the District. Despite weaknesses cited in residential construction, directors thought that total construction activity would remain strong, with increases in industrial and commercial construction, as well as heavy construction, offsetting declines in residential construction. In Montana, however, strikes have currently stopped construction activity.

Several directors noted that high interest rates have not deterred District businessmen from borrowing and that loan demand is strong at District banks. For example, loan officers at a major Minneapolis-St. Paul area bank foresee no slowdown in loan demand in the near future. One director, however, indicated that businessmen are becoming very sensitive to the cost of working capital. Furthermore, some small and marginal businesses are having difficulty in obtaining funds, and some businessmen may have to forego new projects. Some directors suspected that their area banks may be encountering difficulty in accommodating current loan demand. In one area, District businesses are straining to obtain funds and are leaning on their customers to pay their bills; in another, businessmen have encountered difficulties in collecting accounts receivable.

District retailers have enjoyed a good year so far, and several directors expect business to remain quite good. A director associated with the retail trade industry said that his business, which has been strong all year, has even improved recently. But a Twin Cities area banker looked for slack in consumer spending during the last half of 1974. He also mentioned that although retail spending has been relatively better in Minneapolis-St. Paul than in the nation, the unit volume of goods sold in the Twin Cities has changed very little from a year ago. Reinforcing this observation, one director reported a moderation in retail sales growth in his area and indicated that businessmen are not as optimistic as they were two to three months ago. Furthermore, a southern Minnesota director indicated that concern over recent agricultural price declines may dampen consumer spending in his area this summer.

Automobiles have been selling somewhat faster in the District than in the nation in recent months; however, May sales in the Minneapolis-St. Paul metropolitan area were down markedly. Declines were attributed to consumer resistance to higher car prices. Conversely, consumer interest in recreational vehicles has been renewed. The outlook for the District's tourist business this summer is generally quite optimistic. However, a director in the upper peninsula of Michigan indicated that concern with the availability of gasoline has clouded the outlook for tourism in his area.

Generally, the directors felt it was hard to get farm machinery in the District and, since many dealers have large order backlogs, the situation probably would not improve this year. However, the demand may be overstated if farmers are ordering equipment from more than one dealer. Also, the prospects of lower agricultural prices and farm incomes this year may reduce the demand for farm machinery in 1975. A director from western South Dakota said that because of a lack of moisture and concern over agricultural prices, the major implement dealer in his area expects business may be off as much as 33 percent from last year.

Our second quarter industrial expectations survey shows continued expansion in District manufacturing activity. After rising 12.7 percent from a year earlier in the first quarter, District manufacturing sales are expected to increase 15.9 percent in the second quarter, 14.2 percent in the third quarter, and 11.5 percent in the fourth quarter. With an upward revision in the durable goods manufacturing sales forecast, the second and third quarter sales expectations are higher than those made in February.

Nonelectric and electric machinery manufacturers--the District's major durable industries--look for substantial sales gains, while District food processors--the major nondurable goods producers--expect very little growth during the last half.

TENTH DISTRICT - KANSAS CITY

Major retailers in the Tenth District report modest sales increases over last year and appear moderately optimistic about the rest of 1974. Sales of new domestic automobiles have grown more than seasonally in recent months, with some relative movement away from small cars. Lower livestock prices and prospects for a smaller wheat crop than was expected earlier may weaken the District farm income situation. However, little of the substantial decline in meat animal prices has shown up in retail meat prices. Although business loan demand at Tenth District banks remains strong, there are some indications that a slowdown in the growth of such loan demand may be under way.

The retail sales picture continues to be mixed, according to reports from department stores across the Tenth District. Different firms in the same metropolitan area report widely differing growth in sales, along with the usual divergence from city to city. One major retail firm reports that its sales in rural areas are very good but that the sales picture in the metropolitan areas is "not so rosy." While furniture sales are apparently weak, sales of other consumer durables--especially appliances--seem to be fairly strong. Much of the inventory growth reported is said to be almost wholly in dollar terms, with some firms reporting declines in unit terms. Several firms emphasized the high holding costs for inventories as an important influence on their policies. Attitudes of the various respondents toward future sales may be summed up as moderately optimistic.

Sales of new domestic automobiles seem to be showing slightly more than seasonal growth in recent months. Sales are shifting back to large- and intermediate-sized cars, compared to the December through February period.

Buyers seem to be accepting standard engine sizes for a given model but continue to add options such as air conditioning and automatic transmission on all sizes of cars. There may be some movement away from such accessories as power windows and power seats. Reports on inventories vary so much from dealer to dealer that the situation is impossible to summarize.

Sales of imported cars in the Kansas City area have slipped substantially since February, with changing attitudes toward the fuel situation cited as the major reason. As a result, inventories are now very heavy. A Volkswagen dealer feels that the manufacturer simply guessed wrong on the duration of the gasoline shortage and the longer-run attitudes of car buyers, with inventories becoming "burdensome" as demand "fell apart."

Prices and weather continue to dominate the agricultural picture. The latest report on sliding farm prices, which have now fallen about 14 percent since February, offers more evidence that processors and food retailers are allowing profit margins to widen before adjusting their prices. Hog and cattle prices are down 30 percent and 12 percent, respectively, from a year ago, but the decline in red meat prices has been 3 percent or less. This reluctance to pass lower meat animal prices on to the consumer has slowed the movement of meat through the marketing chain and has contributed to an oversupply of heavy animals. Consequently, the livestock industry continues in a depressed financial state. However, on the basis of a recent telephone survey to a limited number of commercial bankers, most cattle loans have been adequately secured during the past year, thereby minimizing the number of bad loans. It was reported that a few rural banks may be in jeopardy because of poor cattle paper.

The District's wheat situation has not improved since the last Red Book. Various reports indicate that drought has destroyed much of the crop in New Mexico and Colorado. Given the recent planting difficulties in the spring wheat regions, 1974 wheat production may fall short of official estimates. However, the crop is still expected to surpass last year's record of 1.7 billion bushels.

The volume of business loans declined substantially during May at weekly reporting banks, thereby providing some indication that business loan demand has perhaps begun to slow. Furthermore, in a survey of large District banks, several reported signs of a cooling in loan demand, as indicated by a reduction in the volume of new loan requests. However, other banks in the survey, in spite of experiencing a decline in business loans in May, still felt that business loan demand was exceptionally strong and was showing no signs of abatement. Whatever the future direction of loan demand might be, it was the consensus among the surveyed banks that current loan demand was quite strong. As a result, virtually all banks were more actively policing compensating balance requirements and repayment schedules.

District banks also experienced sizable inflows of CD's during May. In spite of press reports indicating that medium-sized banks might experience difficulty in attracting CD's in the wake of the problems at Franklin National Bank, apparently that was not the case with larger District banks. None of the surveyed banks reported having any difficulties in attracting and rolling over maturing CD's or having to pay a premium rate on CD's.

ELEVENTH DISTRICT - DALLAS

The rise in retail food prices has been slowing recently at leading grocery store chains in Texas, and executives of these chains expect the trend to continue through midsummer. Lower meat prices have accounted for much of this slowdown, and food chains report that beef prices have dropped to the lowest level in two years--down 10-20 percent from the February peak. However, sales have not rebounded as anticipated because most shoppers now appear to be willing to eat less beef. While total purchases of beef remain depressed, recent buying patterns suggest some consumers are responding to lower prices by resuming purchases of better quality and higher priced cuts. This has led to a slowdown in the sale of vegetable extenders, which accompanied the soaring demand for ground beef last winter.

The reduced demand for beef, coupled with higher marketing costs, is resulting in smaller profit margins for food retailers, according to a representative at one of the leading chains in the state. He points out that over the past year the cost of handling and shipping beef from the feedlot to the meat counter has increased 15 percent, but his stores have been able to pass only about two-thirds of the added expense on to consumers. He expects, however, that because fewer cattle are being fed, beef prices will rise by midsummer as retail supplies are likely to decline.

Cattlemen currently have limited funds for buying animals to place on feed because of the depletion of their equity capital through heavy losses in earnings since last September. Their reduced equity positions are limiting the amount they can borrow from banks. The loan terms of most banks in the Eleventh District require that borrowers maintain an equity investment of about 25 percent in the cattle being financed.

Business loan demand at large banks in the Eleventh District has continued strong through May. A number of these banks were recently surveyed concerning the composition of this demand. While most reported no real change in the composition of loan demand, there was some evidence that long-term business borrowing is being deferred because of depressed bond and stock prices. For example, business loans to oil companies have been strong in recent weeks, and one Houston bank indicated that it was lending to a number of oil companies and gas transmission companies that were using short-term bank funds until conditions improved in bond and equity markets.

Utility rates for gas and electricity in Texas have risen only about one-fourth as rapidly as those for the nation as a whole this year. The wide disparity primarily reflects the cost of producing electricity. Because of the reliance on natural gas as a boiler fuel, electric utilities in the state have largely escaped the dramatic price increases for coal and oil. In addition, production costs and rate increases have been held down because the recent purchases of higher priced gas have been averaged in with existing fuel stocks which were purchased earlier at considerably lower prices. For example, a large electric utility in the state reported that the cost of gas has risen 20 percent in the past year. However, by averaging the newly contracted gas with the lower priced gas purchased earlier, rates paid by customers were raised just 6 percent.

TWELFTH DISTRICT - SAN FRANCISCO

Little change has occurred in the economic outlook of our directors from the previous month. Inflation is the major policy concern. Existing levels of activity are expected to be maintained, with little real growth until the third quarter. Business expenditure on plant and equipment is a major source of strength, but expansion efforts are hampered by shortages. Consumer spending appears to be off somewhat, but there has been a recovery in car sales. Agricultural prospects are excellent throughout the District. Despite record interest rates, there has been little impact on borrowers' demand and banks continue to be selective in making loans.

Businesses continue heavy spending to expand plant and equipment, as pressures on capacity and build-up of orders show little sign of easing. Delays in shipments and shortages are a common problem that is affecting both expansion and current production. Businesses are attempting to protect themselves against the uncertainties of obtaining needed supplies by building up inventories whenever possible. Plastics, basic petrochemicals, steel, and electrical goods are all subject to delays in shipments. Inflation causes additional uncertainty, and contract prices are being quoted as "those existing at time of delivery."

Some of the large California banks report slower consumer spending. The growth of retail spending has continued but at a slower pace, in part because inflation is making consumers more careful. Automobile sales have been recovering, and sales are at higher levels in most areas. Sales of standard-sized cars are better, and some directors report that sales of foreign compact cars are off now that the gasoline shortages have eased.

Higher prices on these cars is another factor in their weaker sales. Foreign luxury car sales, in contrast, are being maintained.

Several directors are concerned about a deterioration in consumer credit and a rise in personal bankruptcies. In one case, a bank president in southern California feels that a similar weakness exists in some major businesses that are continuing to receive "unbelievable" lines of credit from competing banks.

Residential construction shows little sign of recovery, although one large California bank expects modest gains in the months ahead. Nonresidential building, in contrast, reflects heavy investment spending. Activity is high, but the completion of many projects is being hampered by structural steel shortages. A director cites the case of a building requiring 1,300 tons of structural steel, of which reasonable delivery exists for only 500 tons. In some regions, strikes by construction workers might also disrupt building activity. In southern California, a director described several major projects which are being delayed by new environmental controls.

In forest products, lumber prices are lower, but demand for pulp and paper remains good. Producers in this industry also report that supply shortages are hampering production. Agricultural prospects appear to be excellent in all parts of the District. Weather conditions, with few exceptions, have been favorable, and farmers expect good crops with satisfactory prices. Farmers are continuing to expand acreage and to upgrade their equipment, in part to offset labor shortages.

Record interest rates, according to the replies from commercial bankers, have not had any significant impact on loan demand, except perhaps in construction finance. Borrowers are willing to pay going rates and either try to pass the cost on or accept temporary reductions in profits. The problem for borrowers is availability, not prices. Banks are generally more restrictive and more careful in accepting new customers. Business demand is directed toward inventory build-up as well as expansion. Consumer loans show more variation among banks, but credit-card borrowing is continuing to increase.

Borrowing is heavy in agricultural districts, both to finance new construction by food processors and to expand crop production. Additional borrowing needs reflect demands by fertilizer and equipment dealers for cash payment. Dealers in such states as Washington, Idaho, and Utah are ceasing to carry their customers over the growing season. Higher interest rates are not restraining agricultural loan demand.

Inflation remains the major concern of our directors. Opinion is somewhat divided, but a majority think the rate of inflation will become less during the rest of the year. Yet, several directors are worried about the size of future wage settlements and expansionary tax cuts which may stimulate even more price rises.