

CONFIDENTIAL (FR)

CURRENT ECONOMIC CONDITIONS BY DISTRICT

Prepared for the  
Federal Open Market Committee  
by the Staff

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## SUMMARY\*

Economic activity continues to advance, according to this month's district comments. While there is concern in some areas that a downturn may be in the offing, business activity generally appears to be strong with little evidence of current weakness. Some shortages of skilled labor and certain materials have developed, but building activity and industrial production continue to post healthy gains. At the same time, capital goods orders are strong, suggesting that capital spending will expand further. Retail sales generally remain robust, and inventories appear to be at moderate levels. Furthermore, higher farm prices and good crop prospects have improved the outlook for agricultural incomes. Demand for bank credit appears to be strong and broadly based.

Moderate to strong gains in consumer spending were reported in most districts, although Cleveland and Dallas experienced some recent softening. Sales continued to be vigorous in most of the San Francisco District, but some hesitancy was noted in California in response to uncertainties about the impact of passage of Proposition 13. Automotive sales were strong in many areas of the country. Nevertheless, sales were generally not expected to continue at the current brisk pace. Richmond, for example, reports that at least part of its strong auto loan demand reflects buying in anticipation of higher prices.

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\* Prepared by the Federal Reserve Bank of New York

Retail inventory levels generally appear to be in good balance with overall sales, although some overstocking in a few lines was noted by several districts. Major exceptions to this view were New York, where several merchants expressed concern that stocks were higher than desired, and Cleveland, where the level of inventories of a wide range of merchandise is considered high. In general, retailers appear to be optimistic about the near-term outlook for sales.

Among those districts reporting on building activity, most are continuing to experience relatively high levels of residential and/or nonresidential construction. Atlanta reports little or no slowdown in housing starts or mortgage lending to date, and nonresidential construction is also at a rapid pace. Housing activity also remains high in the St. Louis and Cleveland districts and in the latter, most lenders report no slowing in mortgage commitments and loan applications. Dallas characterizes nonresidential construction as the fastest growing sector in its regional economy and notes that home building is also strong. Faced with rapid growth, both Dallas and Minneapolis cite shortages of cement as a constraint on their building activity. Nonresidential construction remains high in San Francisco though home building has slowed. A recent spurt in California residential permits reflects the imposition of more costly energy regulations beginning in July rather than a pickup in activity. Many of the districts reported that the new six-month money market time certificate resulted in better-than-expected deposit flows to thrift institutions. Chicago and St. Louis note a leveling off of

mortgage rates in their areas.

Industrial activity expanded in many areas during July. The volume of new orders was strong in the Boston, Cleveland, Philadelphia, and St. Louis Districts, while order backlogs have increased sharply for transportation equipment in Chicago. A survey in the New England area indicated that 80 percent of small businesses had higher backlogs than a year earlier. Manufacturers responding in the monthly Philadelphia and Richmond surveys also reported gains in shipments and employment. Boston and Chicago report some industries operating at or close to capacity. While inventories rose in the Richmond District in contrast to a decline in Philadelphia, Richmond manufacturers state that inventories more closely approximate desired levels than in earlier months. Activity in the steel mills of the Chicago and Cleveland Districts is reported to be robust. Chicago steel producers are witnessing the best demand in four years and orders in Cleveland have been strong due to automotive demand and some stockpiling in anticipation of an August price hike.

The outlook for continued growth in capital expenditures appears promising, judging from the reports of districts commenting on capital spending. Cleveland expects good business fixed investment ahead based on strong orders in its capital goods industry. At the same time, producers of machine tools and other capital equipment in some other districts report strong new orders. Nevertheless, there were a few reports of continuing caution. For example, Philadelphia's manufacturers expect to "hold the line" on such spending.

Prospects for agricultural incomes in much of the country have brightened considerably. Higher prices for livestock and crops, along with a good harvest in view have raised farmers' expectations. Chicago contrasted the current farm situation to the dismal conditions of last winter that prompted a strike. San Francisco says its farmers are in the process of recouping the losses from the heavy spring rains. As a result of the improved financial situation, sales of farm equipment and farm spending in general have risen and loan repayment problems have declined. However, as Kansas City notes, continued reduction in beef production together with liquidation of cattle inventory indicate even higher meat costs for consumers in the months ahead.

Demand for bank credit was reported strong in most districts. The source of recent demand appears to be broad based. Business loans were strong in Philadelphia and St. Louis while Kansas City had heavy demand for real estate loans and Dallas for real estate and construction loans. Consumer borrowing was a major source of bank loan demand in the Richmond and New York areas. Consumers in the Chicago District also made liberal use of credit. So far, there is no evidence of an increase in delinquency rates. Minneapolis and Dallas were the only areas to mention the possibility of a liquidity problem.

## FIRST DISTRICT - BOSTON

Redbook participants in the First District are anxious about the impact of a potential 1979 recession on their own businesses but at the same time see no concrete evidence that a slowdown will actually take place. No significant deterioration in economic trends was noticed over the past month. Loan demand remains healthy and is growing very strongly in some areas. Several manufacturers report substantial increases in output and some indicate they are operating at close to capacity. Retail sales continue to be strong although not growing as fast as before. Inventories are not generally considered a problem. No shortages of materials were reported although some labor markets have tightened considerably.

A Connecticut Director reports strong increases in industrial activity in that state. Several manufacturers of defense products including airplanes, helicopters, submarines, and tanks, have substantial backorders that will occupy them for several years. New orders for consumer products are also very strong. As a result of the substantial increases in manufacturing activity large employers in Connecticut report increased difficulty in obtaining experienced workers and the need to rely more upon training programs.

A survey of small businesses in New England indicates substantially expanded manufacturing activity across the region with 80 percent reporting higher backlogs than a year ago. However, two producers of consumer durables reported some slowdown in sales of major appliances and housewares. Both of these firms expect a decrease in housing starts to have some impact on their sales next year.

A Vermont Director reported very strong increases in loan demand and the need for his bank to police credit commitments much more carefully. A

large Boston bank reports continued strong, although not spectacular, loan demand with some leveling off following expected seasonal patterns. Loan officers at this bank are forecasting a resumption of loan demand growth this fall and its Chief Executive Officer expects interest rates to continue to increase until the end of the year.

First District retailers report that sales remain healthy. Although some minor adjustments in inventory may be called for no major corrections are expected. Tourist business across New England has also been very heavy this season. Several Directors commented that they have seen some evidence of changes in spending patterns brought about by the increase in the cost of foreign products and travel.

Professors Houthakker and Samuelson were available for comment this month. Because the current trend rate of inflation, based on wage and productivity considerations, is about 8 to 9 percent, Houthakker does not see a peak in long-term interest rates. He notes that beef cattle herds are not now being rebuilt, a corrective action will be necessary to reduce beef prices in the long run. Houthakker is encouraged, however, by the increases in exports and regards the June trade figures as "not necessarily a fluke." Continued strong performance would bring greater strength for the dollar with respect to European currencies but not the yen. On the basis of a recent visit to Japan, Houthakker found the Japanese have done "nothing" to remedy their trade imbalance and appear adamant about doing nothing in the future. Houthakker agrees with the stated monetary target ranges and hopes they will be met. Although he has traditionally found M1 the more meaningful aggregate, he has been impressed by the arguments that it may be losing much of its significance.

Samuelson notes that most forecasts now cluster around a mini-recession view of two or three quarters of real growth of about 2 3/4 percent. He feels 3 percent real growth would be tolerable and agrees with Chairman Miller that a "preventative recession" would not be desirable. The Fed should not cheerfully countenance the prospect of weaker real growth because that would set into motion forces that could bring further weakness with little diminutive effect on inflation. To show a responsible concern for inflation the Fed must gauge how much of the increase in prices is related to excessive demand. For a tolerable real performance, GNP will need to grow at least 10 percent. Because "velocity cannot always save the bacon," this will require money growth at the top or occasionally above the current ranges.

## SECOND DISTRICT--NEW YORK

Recent comments of directors and other business leaders indicate that economic activity in the Second District is continuing to grow at a moderate pace. Gains in retailing appear to be somewhat mixed; but overall inventories are moderate. Outside of the consumer sector, agricultural incomes are being bolstered by high prices and sizeable harvests. New orders for durable goods are strong, although the outlook for capital expenditures remains cautious. There is little evidence of any unusual tendency of firms to add work shifts rather than investing in new plant and equipment. On the financial scene, respondents voiced little concern over prospects of a liquidity squeeze at either financial or nonfinancial firms. Thrift deposit flows at large savings banks appear to be benefiting from the introduction of the new six-month certificates.

Gains in sales at major New York City department stores varied among respondents. One department store executive reported "weak" business in July, while other respondents characterized sales as "good" or "excellent". Several respondents experiencing brisk sales attributed part of their success to heavy promotional campaigns. Current inventories are clearly above the level of a year ago and several merchants expressed concern that inventories were somewhat higher than desired. Generally, however, retailers judged the build up in the stocks of inventories as moderate and anticipated that sales in coming months--buoyed by seasonal promotional campaigns--would reduce any excesses. Among product lines, home furnishings stocks, in particular, were noted as high relative to sales. According to respondents

with outlets in New York City and other parts of the District, merchandising in New York City appears to be outpacing other outlets.

Consumer spending outside of department stores remains strong with new automobiles continuing to sell well. Several directors felt auto inventories were inching upward; but these increases were judged as failing to keep pace with the optimistic sales outlook, and there were scattered reports of inventory shortfalls. Several leading dealers reported shortages of specific models and depleted inventories were retarding sales. One respondent contended that sales could be as much as twenty percent higher if orders were adequately filled.

The economic outlook for the upstate area remains cautiously upbeat. Producers of machine tools and other capital equipment continue to do good business: new orders are strong at most firms, and one supplier related reports that some companies had expanded into third shifts in an attempt to shorten delivery lags. In general, however, directors noted no unusual tendency for firms to expand production by adding work shifts. Agricultural incomes in western New York have been bolstered by sizeable harvests and unexpectedly high prices for cherries, cabbage and corn. As a consequence, agricultural equipment reportedly has been selling well, although one upstate director attributed part of this strength to a growing sentiment among farmers to buy now in order to beat inflation.

Respondents' views of the financial outlook were varied, but all agreed there were few signs of an impending liquidity crunch. The president of a major New York City bank noted that his economists were predicting a loosening of credit around year's end. Another leading banker foresaw no

serious problems, but thought thrift institutions were becoming a bit more vulnerable. Banking directors of the Buffalo branch observed some tendency for companies in the Rochester area to increase their lines of credit--perhaps in anticipation of future difficulties in obtaining funds for capital expenditures. Still, commercial lending in the upstate region has not changed much of late, though installment loans and credit card outstandings are up substantially over a year ago.

Elsewhere on the financial scene, a survey of New York mutual savings banks indicates that the new six-month time certificates are augmenting deposit flows. Indeed, one senior official at a leading savings institution felt that the new instruments had led to a reversal in the pattern of outflows typically experienced at this juncture. Most contacts were somewhat more reserved in assessing the success of the new certificates. Echoing the view of many respondents, the chairman of major savings bank held that the certificates had moderated the deposit outflows. In terms of the impact of the new certificates on the profitability of thrift institutions, respondents at large savings banks felt that the new instruments would raise profits since their mortgage lending is implemented by purchasing pass-through securities at rates that exceed New York's usury ceiling. There was concern, however, that the profitability of smaller mortgage lenders, which primarily serve local markets, would be adversely affected.

## THIRD DISTRICT - PHILADELPHIA

Indications from the Third District are that economic activity has picked up in August. The industrial sector is posting strong gains after a seasonal slowdown in July, and retailers report current sales to be well ahead of year-ago levels. For the longer term, manufacturers expect to hold their ground in terms of sales between now and February, but project a slight cut in employment. Retailers on the other hand, look for strong gains to continue throughout the next six months. Inventories are expected to remain unchanged over the period. Commercial bankers in the area say business loan demand is up, but have mixed views about future demand. All banking contacts expect interest rates to peak within the next six months.

Manufacturers responding to the August Business Outlook Survey say business is better this month after a seasonal lull in July, with over one-third of the respondents reporting an improved business climate in August. Supporting the claims of a pickup, responding manufacturers say both new orders and shipments are up over last month's levels. At the same time, factory work forces have grown fractionally and inventories have declined. A Director of this Bank agrees with these reports. He claims his business, in the nondurables manufacturing sector, has been doing well all summer and continues strong in August.

For the longer term, Survey participants say they expect to maintain the status quo over the next six months. Consistent with this projection, local manufacturers foresee only a marginal increase in new orders between now and February, with no change in the number of shipments at all. Consequently, businessmen seem to be taking a "wait and see" attitude with

regard to business decisions. They plan to maintain inventories at their current levels and expect to hold the line on capital spending as well. Although no actual decline in business volume is anticipated, the lack of bullishness in the outlook might spell bad news for the local labor force. For the first time in the current recovery, Survey respondents say they plan to cut payrolls fractionally, and trim the length of the average workweek as well.

On the price front, manufacturers again report higher prices in the industrial sector. Over half of those polled this month report paying higher prices for raw materials, while about one-fourth say they're charging more for their finished products. Price increases are expected to become more prevalent over the next six months, with 77 percent of the executives surveyed projecting higher prices for inputs and 62 percent planning to hike the prices of the goods they sell.

Department store executives in the area say sales are very strong in August, a month that is usually soft. Reports of current dollar sales range from 8 to 26 percent over year-ago levels and up to 10 percent ahead of plan. This makes the fifth straight month in which gains have been posted by the local retail sector. Merchants attribute the continuing strength to several factors including favorable weather and an effort on the part of consumers to beat future price hikes by spending now instead of later.

This "buy now" attitude does not seem to be representative of businessmen with regard to inventories, however. Reports of stock levels range from "on target" to "a little thick" at this time. Those merchants with excess inventories expect to reduce their stocks to desired levels over the next six to eight weeks. Aside from this, businessmen foresee no changes

in inventories (other than seasonal) between now and February. A Bank Director confirms these views.

Retail sales forecasts for the next six months vary, but merchants are generally optimistic. Most of those contacted say they don't believe that consumers are likely to overextend themselves during the period. Sales projections for the beginning of 1979 range from 5 to 13 percent over year-earlier levels. Although those at the lower end of the scale note that their projections for nominal growth probably imply no real gains, they point out that year-earlier levels were extraordinarily high and believe it will be difficult to top them by a wide margin.

Area bankers say consumer loan demand is mixed but that business loan demand is up by as much as 8 percent over the same period last year. The reported levels of C&I loans are generally as planned or slightly better. As for the future, commercial bankers have mixed views. Forecasts range from virtually flat loan demand through early 1979 to a gradual pickup and possibly a boom.

The prime rate at all of the banks contacted is currently 9 percent. All contacts feel interest rates will top out sometime within the next six months, but differ as to when a peak will occur. Estimates of the peak prime range from 9 1/4 to 10 1/2 percent, with those people projecting a later peak at the upper end of the range. None of the bankers contacted have observed disintermediation at their institutions and do not consider it to be a potential problem at this time.

## FOURTH DISTRICT--CLEVELAND

Overall Fourth District business activity remains good but there are some signs that its pace may begin to slow. Area retailers indicate sales may be softening, and automobile sales are not expected to continue at their current brisk pace through the fourth quarter. There are some indications that housing activity is plateauing; but despite favorable savings lows, higher mortgage costs may be necessary to balance the existing demand. Capital goods orders continue very strong, suggesting a favorable outlook for business fixed investment. Steel orders also are at high levels and steel imports fell in May and June. The city of Cleveland continues to move toward insolvency.

Area retail sales began to soften in July after the high levels earlier this year. An economist with a major department store group expects real consumer outlays to increase about 2 percent in the second and third quarters because of slow real income growth, high debt accumulation, and anticipatory buying. Consumers appear to be more price conscious, and retailers, particularly the large discount chains, are aggressively competing for market shares. Not much, if any, improvement in profits is likely this quarter. Inventories of a wide range of merchandise are characterized as very unfavorable.

Despite some decline during July, new car sales are still above year ago levels and better than many industry analysts had anticipated. Industry economists do not believe the anticipatory buying thesis satisfactorily explains the recent high levels of auto sales. Inventories, which appeared

large and unbalanced last month, seem more manageable at present. Observers would be surprised if the robust pace of auto sales experienced in recent months were maintained through the fourth quarter. Light truck sales continue at high levels and inventories are being worked off.

There is some evidence that the District housing market may have plateaued but activity remains at the high level. Respondents said houses are remaining on the market longer, and the scattered reports of sales above the asked price are no longer heard. While housing activity may be leveling, most area lenders do not perceive any slowing in commitments or loan applications. Area S&Ls report good deposit flows in June and July, but at insufficient levels to meet existing demand. High-yield money market certificates are responsible for these strong flows, with about 55 percent of the funds now attributable to new money. Borrowing from the FHLB, at record levels in recent months, should subside as starts moderate.

District economists expect that business fixed investment will remain strong through the year. Machine tool orders are reported at very high levels. Though the industry is near capacity, bottlenecks have not surfaced. Various capital goods producers report that orders are strong from the aerospace, automobile, construction and railroad industries. Orders from the steel utility and mining industries show weakness. Exports, too, are sluggish.

Steel orders have also been strong largely because of demand from auto producers and some inventory building in anticipation of August 1 price increases. Still, production over the next two quarters may be slow, depending on the auto industry needs and the rate at which recently accumulated

inventories are depleted. The industry, operating near capacity, does not anticipate capacity constraints in the near future. Aluminum tonnage fell slightly in the second quarter, but the level of backlogs speaks favorably for production through year-end. Overall, the industry is below capacity, but flat-rolled capacity is being added to meet growing auto demand.

Steel imports fell in May and June largely in response to the trigger pricing and inventory building prior to its effective date. Imports equaled 1.36 million tons in June, down almost 38 percent from April. The steel industry, however, took little comfort in the decline; it had hoped imports would fall to 1.0 million tons. Industry officials are also concerned about the growing market share held by non-EEC and non-Japanese producers. Their share has risen to about 40 percent recently from a normal 20 percent. While formally bound by the trigger price program, these countries are claiming to produce at costs below the Japanese who form the benchmark for the trigger prices. Overall, the steel industry still is maintaining a wait and see attitude toward trigger prices. One industry economist believed that the appreciation of the yen was now just beginning to blunt Japan's competitive edge in specialty steel.

The city of Cleveland continues to move toward insolvency while the administration is preoccupied with an August 13 recall election. To finance the city's estimated \$2.2 million deficit per month, the city has been transferring bond retirement revenues to current operating funds. Four developments threaten a major financial crisis in September: Cleveland is under court order to repay a \$20 million debt to the Cleveland Electric Illuminating Company; funds to meet the \$2 million bimonthly police and fire

payrolls are expected to be depleted by September 20; the bond retirement funds, the last major revenue source available to finance the existing operating deficit, is depleted and finally, the city must roll over \$3.34 million in notes on September 9. Recently Moody's downgraded and Standard Poors suspended Cleveland's rating on bonds and notes. The action taken by these investment services makes the refinancing of Cleveland's paper virtually impossible without an audit.

## FIFTH DISTRICT -- RICHMOND

With a few exceptions, business activity in the fifth district remained firm in July with most indicators continuing to show moderate to strong expansionary tendencies. In the manufacturing sector, responses to our survey suggest continued output growth as employment, weekly hours, and shipments rose moderately. On the other hand, new orders and backlogs of orders were essentially flat for the second consecutive month. Retail sales were broadly higher in July although relative sales of big ticket items held steady. Bank credit growth in the fifth district continues strong, due primarily to household demand for instalment loans. Real estate lending at banks and thrifts is also a continuing source of strength. Business lending, although somewhat moderate in recent weeks, is nonetheless healthy.

Manufacturers surveyed this month report little or no overall change in the volume of new orders or in backlogs of orders. Nonetheless, shipments continued to expand moderately and employment and weekly hours rose somewhat. Inventories of materials and finished goods were also up over the month. However, current stocks more closely approximate desired levels than at any time in recent months. Regarding the price situation, more than half of the manufacturers surveyed report paying higher prices in July and over 40 percent received higher prices.

Among retailers surveyed sales were generally up over the past month while relative sales of big ticket items held steady. A majority of respondents experienced rising inventories in July, but most continue to view current levels as about right. Employment was unchanged from a month earlier. Prices,

including employee compensations, were broadly higher over the most recent survey period. Richmond directors perceive continued strength in household credit demand and feel that expectations of higher prices are fueling current consumption, particularly of durable goods.

Expectations remain negative in the manufacturing sector as nearly half of our respondents anticipate a worsening in the level of business activity, nationally and locally, over the next six months. Expectations are neutral, however, for level of production in the individual firms. Retailers in our survey have lowered their expectations considerably of the past month, and now foresee little change in activity over the next six months. Our directors are not at all optimistic with regard to the outlook for prices. Most expect little or no improvement in the inflation area during the second half of the year.

Although deposit flows are holding up well, banks and thrifts generally feel that their liquidity positions have tightened somewhat. The strong activity in consumer lending has come as a surprise to most banks, as expectations about loan volume in July have generally been exceeded. As a result, many lenders now expect consumer lending activity to remain strong in coming weeks. Strength in new car sales is the major factor explaining consumer instalment loan demand, and anticipatory buying to avoid higher future prices is cited as an important motive behind the strong sales. Some banks have recently raised the interest rates on auto loans, but these increases have not affected demand.

While lending to business has moderated in recent weeks, commercial and industrial loan demand remains strong. Moreover, some banks report large

amounts of new bookings in process. Borrowing seems widely dispersed among type of borrower. Our contacts report only isolated cases of short-term-borrowing to finance unwanted inventory. One such case, however, is in the textile industry, where the demand for denim fabrics is proving to be much less than expected. Noteworthy is the fact that area banks rate the credit worthiness of their business customers as being quite good; this view is also supported by our banker directors.

Demand for mortgage loans appears to have been strong in July, and fifth district thrift institutions described their liquidity positions as being comfortably tight to tight. Thrifts in Maryland appear to be particularly pressed for funds, and many have raised their conventional loan rate to 10 percent (the state usury ceiling) with a one-third down payment required.

Our farm credit survey for the second quarter of 1978 revealed that district bankers have experienced further improvement in loan repayment rates and a significant decline in the number of requests for renewals and extensions since the first quarter. Indications are, however, that a growing proportion of banks serving district agriculture are currently faced with liquidity pressures. While farmers' demand for short-and intermediate-term credit from commercial banks was weaker, on balance, demand for consumer and business loans continued strong and bank supplies of loanable funds were much less than usual. Loan-to-deposit ratios of reporting banks, in fact, were at the highest level in almost three years. Bankers forced to refuse or reduce a farm loan because of a shortage of funds rose relative to the total, while the share actively seeking new farm loan accounts dropped further. Bank interest rates on farm loans rose significantly, as might be expected.

While total planted acreage of principal district crops this year is down about 1 percent from a year ago, major cuts were made in the acreages devoted to cotton, corn, and wheat, offsetting the large increase in soybean plantings. Even though most crops got off to a late start because of the cool, wet spring, they have responded well to the generally better growing conditions than those prevalent last year. Gains in yields per acre are currently indicated for flue-cured tobacco and for all feed and food grains.

## SIXTH DISTRICT - ATLANTA

Businessmen in nearly all industries seem to share the opinion that growth is currently at a peak, will continue strong for a few months, and will slow by year-end. There are some signs that an easing of growth has already begun, however. Labor markets are tight, with job gains slim; retail sales are "holding up well" but probably advancing little in real terms. Loan growth has moderated; deposit gains have quickened. Housing markets are starting to make some observers uneasy. The strain on supplies of construction materials and transportation has increased. Crops appear to be bearing the hot, dry weather well.

Retailers characterize sales gains as roughly in line with inflation, perhaps slightly better, with strength distributed pretty evenly across items. Most are anxious to get their inventories down--some because of high financing costs or style changes, others because they consider sales prospects questionable. Larger-than-usual, widespread markdowns have helped many to bring stocks close to desired levels. Unit automobile sales remain well above the year-earlier pace, but the gains have been shrinking.

Consumer delinquencies have edged up but are not posing problems. Insurance companies have seen no increase in borrowing against life insurance policies, which they construe as evidence that consumers are not strapped financially.

At both banks and savings and loan associations, deposit inflows picked up in July. The six-month certificates have gained acceptance and contributed substantially to the advance. Loan demand has stopped accelerating but is still rising.

Statistics for the six District states have shown negligible job growth since early spring. Businessmen seem not to have perceived the weakness, describing employment as high, and their announced hiring intentions are bullish. Labor force expansion has been very slight, according to official estimates, but contacts continue to note substantial migration from outside the region. At any rate, shortages of skilled technical and construction workers have become more acute in the coastal areas. For example, Ingalls Shipyard, which is in the process of substantially reducing its work force, has been advertising heavily for skilled tradesmen.

Supplies of many industrial goods are growing ever tighter as well. A large aircraft manufacturer documented a sharp lengthening of lead times for a wide variety of materials, particularly raw aluminum, although its price increases have not been extreme. (It blames the short supplies, in part, on OSHA regulations which have driven small foundries out of business.) Sheetrock is now on allocation.

Trucking and rail transport are groaning under a heavy load, with no letup yet in sight. A railcar plant, closed a few months ago, has been reopened; other producers are operating full steam.

For the first time in many months, all of our respondents had some negative comment on residential construction. There has been little or no slowdown in starts or mortgage lending to date. But Florida observers are uneasy with the rapid pace of activity. Speculation may have pushed the supply above the demand; many buyers appear to be willing to pay 20-25 percent more than they had planned with little consideration. In other states, observers feel that prices have begun to dampen the

market. A director noted that builders were finishing homes without finding buyers where they had been making sales before breaking ground a few months ago. Suppliers to the residential construction industry are looking for a slowdown by year-end. A manufacturer of aluminum and fiberglass screens has begun to trim inventories of both raw materials and finished products in anticipation.

Producers of materials for nonresidential building also feel that current feverish activity cannot be sustained. One steel company analyst says, "we're looking over our shoulder"; its orders have slowed somewhat. A pipe manufacturer remarked that a number of large projects (such as nuclear power plants, refineries, and chemical plants) have been postponed because of uncertainties, largely in the energy area. In contrast, a director noted that many small projects which had been delayed are getting under way because of the fear of even higher costs.

A significant exception in the outlook is the oil and gas industry. Sources close to the industry expect another 40-percent increase in offshore Gulf wells in 1978. Drilling activity apparently stalled a couple of years ago when the energy debate began; now, lessees must develop their older lease holds or lose them. The number of newer leases ensures that this industry's business will be quite strong for the next few years.

Hot, dry weather has been troubling livestock producers and damaged the corn crop in the southern parts of Alabama and Georgia again this year. Despite the short soil moisture, other crops are rated in fair to good conditions. Agricultural prices have shown divergent trends, with corn, cotton, soybeans, and broilers down and eggs, vegetables,

and tobacco up sharply. Slaughter of livestock, particularly calves and cattle, continues to slide.

## SEVENTH DISTRICT - CHICAGO

Activity in the Seventh District apparently continued to rise in the summer, allowing for plant-wide vacations, and other seasonal developments. Employment and retail sales remain vigorous. Inventories are generally in good balance, and procurement problems are minimal for most businesses. Prospects remain favorable for overall growth in capital spending. Although shortages are infrequent, important sectors are operating at virtual capacity, and there is little overall slack in the economy. Housing appears to have been much less affected by tight credit than had been feared. Crops are developing at an excellent rate. Farmland values increased substantially in the second quarter.

A frequently expressed view holds that a recession will begin late in 1978 or early in 1979. Little or no evidence of current weakness is offered to support this position. In fact, a number of sectors are doing better than had been expected a few months ago, including housing, steel, paperboard, retail trade, transportation, and agriculture.

Consumers are using credit liberally to buy goods and services. Retailers who follow developments very closely find no evidence that delinquencies have increased. Airline travel continues at a "phenomenal" pace with July 18 percent above year ago. Credit card travel is up 35 percent.

Except for special castings and certain building materials, there are few serious procurement problems. Nevertheless, there is not much slack in the general economy. Competent workers are hard to find, and job hopping is on the rise. The railroads, truckers, and airlines are operating at or near capacity. Order backlogs for transportation equipment of virtually all types are up sharply. Other sectors operating at virtual capacity include machine tools,

construction equipment, paperboard, aluminum, oil refining, cement, gypsum, and, in the case of one major producer, steel. The failure of basic industries to expand, or even to maintain capacity in recent years, may preclude faster growth.

A freight car producer booked a record volume of new orders in the second quarter. Demand for heavy trucks and trailers has been at or near record levels, partly because of diversions of traffic from rail. At one plant producing heavy trucks, 1,000 workers continued to work during the plant-wide vacation to finish units in need of special work.

Reports that steel orders had slipped in early July proved to be unfounded, except for oil country goods where inventories had been boosted by a 50 percent rise in shipments in the first half. Demand is broadly based. One analyst reports steel demand this summer to be the strongest since 1974.

Forecasts of 1978 sales of cars and trucks have been raised recently. Sales of cars and light trucks are expected to be about as large next year. Heavy truck sales, however, are expected to decline from current "artificially" high levels.

Large S and Ls have been using T-CDs effectively to stanch the outflow of funds. Mortgage rates have leveled off in the 9.75 to 10 percent range. Transactions in existing houses have held up well. There is no significant overhang of unsold new housing units, as in 1973-74. In fact, many builders are behind on completions because of shortages of materials, and (more frequently mentioned now) skilled labor. Residential permits for the Chicago area were above year ago in June, after pronounced weakness in earlier months.

The City of Chicago's sale of tax-exempt bonds for relending on properties in the city has been hailed as a useful step to arrest urban decay. However, less than \$100 million has been raised, and mortgage volume in the city

exceeds \$1 billion annually. Mortgage funds offered at 8 percent were quickly absorbed by a swarm of applicants.

Prospects for commercial and industrial buildings are favorable into 1979. Orders for fabricated structural steel, construction contracts, and announced plans support this view. Thirteen large office buildings and four expansions are underway, or definitely planned, for Chicago's downtown area. These projects would add 12 million square feet of space, or 20 percent, to the inventory. Vacancies are very low in high-grade structures.

Despite a late start, corn and soybean crops are developing nicely throughout the district. If estimates of large yields prove correct, storage facilities will be inadequate because much of the 1977 crop is still on hand. With higher prices for crops and livestock, the prosperous farm situation is in sharp contrast to the conditions that brought on the "farmers' strike" last winter. Farm equipment sales have picked up dramatically, and production schedules have been raised. Loan repayment problems at country banks have improved further, especially in Iowa. (Delinquencies on equipment loans by captive finance companies had not increased significantly at any time.) Our survey of country bankers shows average farmland values rising 4 percent in the second quarter to a level 8 percent above year ago. The rise in farmland values is especially marked in Wisconsin where purchases for nonfarm purposes are relatively more important.

Virtually all manufacturers took scheduled plant-wide vacations in July and August, despite rising backlogs in some cases. Plant shutdowns are so widespread as to hamper analysis of underlying trends. Managers frequently take vacations at the same time as the plant work force.

## EIGHTH DISTRICT -- ST. LOUIS

Reports from Eighth District businessmen indicate a continued moderate rate of economic expansion in recent weeks. The manufacturing sector continued to post gains in sales and employment in several important industries. Home construction remains at a relatively high level, partially aided by a large backlog of orders. Retail sales were up moderately. Some savings and loan officials have become more optimistic about the outlook for growth of savings deposits as recent gains have exceeded expectations. Credit demands have continued generally strong, but interest rates have changed little over the past month. Field crops are progressing satisfactorily over much of the District, reflecting generally adequate soil moisture.

Retail sales at department stores continued to register moderate gains in July, and retailers remain optimistic about sales prospects over the coming months. Some retailers in the St. Louis area noted little advancement in sales of large appliances. However, over most of the District, retail sales were reported to have increased at about the same pace as in the first half of the year. No serious inventory problems were reported.

Several manufacturing industries, including paints and coatings, chemicals, transportation equipment, building products, and agricultural equipment, have registered recent gains in orders. A representative of a paint and coatings firm reported that sales volume was very good and expressed cautious optimism about future sales. A major chemical firm had increased sales for July in several product lines, including agricultural and industrial chemicals, textiles, and plastics. A sizable fall off in sales,

however, occurred in some intermediate chemicals. A manufacturer of railroad cars reported substantial improvement in sales over the past three months and order backlogs of double the level of a year ago. However, it was pointed out that the pickup in demand for railroad cars partially reflected rising inefficiency in railroad car usage. A major aircraft manufacturer also experienced increased sales and a lengthening in backlogs of orders, due mostly, in this case, to rising sales of military aircraft. Another manufacturer of diversified products reported a 15 percent increase in order backlogs.

Home sales remain at a generally high level in the District. However, industry representatives continue to expect some slowing later this year. New home sales in the St. Louis metropolitan area are reported to be down slightly from a year ago, declining moderately in the higher-cost areas nearest the center of the city, and accelerating in the lower-cost outlying areas. New single-unit home construction continues at a faster rate than the sale of new homes as builders are operating on the large backlog of orders accumulated over the past year. Construction of multi-family residences, while still at a fairly low level, is beginning to increase. In some areas vacancy rates are quite low and apartment complexes have waiting lists.

Savings and loan officials noted that while net inflows of savings have increased at a slower pace than last year, the rate of increase has unexpectedly accelerated in the past two months. The recent increase was partly attributed to the new six-month and eight-year certificates. Officials reported that somewhat less than 50 percent of the funds entering the new certificates are from existing accounts.

Loan demand remains generally strong. Banks continue to experience

a surge in demand for business loans; however, mortgage loan demand, although strong, is somewhat less vigorous than last year. Mortgage lending rates have remained essentially unchanged in recent weeks at a 9-3/4 percent rate for loans with a 20 percent downpayment. One bank official expressed some concern about the future availability of funds should a credit crunch develop. He noted that country banks, which often supply funds to larger banks during such periods, are currently loaned up, reflecting unusually strong demand for agricultural loans.

Prospective yields for field crops are good, reflecting adequate soil moisture. Very hot weather in the southern portion of the District is said to be favorable for the cotton crop, although it may hamper soybean yields. Livestock prices are generally favorable for expansion of livestock feeding. Poultry production has been expanding rapidly in the District and hog production is also expected to make gains later in the year.

## NINTH DISTRICT -- MINNEAPOLIS

Most district businesses had a good July and, despite short supplies of construction inputs, the economic outlook for the next few months is good too. Retail sales, especially of hard goods, held up or increased throughout the district. Production on and off the farm maintained a brisk pace. Inventories of most goods remained tight but adequate. And financial institutions continued to witness strong demand for credit. But concern over developments in the building sector persists as a shortage of cement has swelled the list of scarce construction inputs. Nevertheless, most observers expect economic conditions in the district to change little during the next few months.

A good July

Our Bank's directors indicated that July retail sales equaled or surpassed retail sales posted for June in just about every part of the district. And June was a good month for retailers.

Consumer durables continued to be big sellers. As evidence one director noted an extremely large July increase in installment sales. Also automobile and truck dealers were reportedly moving their stock at very rapid rates.

Our Bank's quarterly survey of agricultural lenders revealed that farmers have been participating actively in this year's retail spending spree. Ninety-eight percent of the agricultural bankers responding to that survey reported that spending by farmers was at or above last year's level.

The reason farmers have loosened their purse strings is a substantially improved income situation. Ninety-five percent of surveyed agricultural lenders said farm earnings were at or above last year's levels. And Bank directors confirm that finding, pointing to high livestock, dairy, and poultry prices and somewhat improved prices for crops.

Farmers and retailers weren't the only businesspeople having a good summer either. A South Dakota director reported tourism had picked up rapidly since July 4 and was running ahead of last year. A Minnesota director said production at his firm was up about 15 percent over last year. And characterizations of industrial activity by other directors ranged from "good" to "booming."

Even though industrial activity has been brisk, most businesses have pursued cautious inventory policies. Thus while one Minnesota director reports some retailers are slightly overstocked and farmers have large quantities of stored grain, for the most part inventories are tight but adequate.

One industry finding itself in an extremely tight "inventory" position is the banking industry. The supply of lendable funds at district banks is barely keeping up with the demand for those funds. These developments have increased bank earnings at the same time they have pushed up the price of credit.

As usual concerns over the well-being of the construction industry have increased with the price of credit. But this month building businesses have been hit with the additional problem of concrete shortages. This shortage, which has affected much of the western U.S.,

has been exacerbated in our region because equipment failures shut down a large Montana cement plant. The other major cement plant serving the western portion of our district, South Dakota's state-owned facility, is rationing its output amongst customers, allocating each of them about one-half of the amount it purchased last year. This has led some builders to turn to Canada for much-needed supplies.

The outlook is good

Production of cement is due to resume shortly in Montana, so builders can look forward to some relief from the cement shortage. Also, while tightness in credit markets is likely to persist and skilled labor markets have been and will probably remain tight as well, builders have been able to cope ably with those conditions. Furthermore, they have large work backlogs to keep them busy through the summer and into the fall. So the near-term outlook for construction, the sector which has been the major concern of most observers, is really pretty good.

The near-term outlook for other sectors is pretty good too. Directors indicate that retailers are looking forward to strong back-to-school sales in August, farm income prospects for the rest of the year are good, the cautious inventory policies that most retailers and manufacturers have been following should cushion them in the event of a deterioration in demand, and financial institutions are likely to continue reaping the benefits of strong loan demand in the coming months.

## TENTH DISTRICT—KANSAS CITY

Industries in the Tenth District are paying higher prices for materials inputs, but are experiencing no problems of availability. Materials inventories are generally satisfactory, and most industries are operating below capacity. A problem exists in some areas, however, with a gasoline shortage described as becoming critical. Retail sales are strong, and retailers are generally optimistic for the remainder of the year. Continued reduction in beef production, together with further liquidation of the cattle inventory, implies no relief in retail meat prices in either the short-run or the intermediate term. Loan demand at District commercial banks is strong, while deposit growth is moderate.

Purchasing agents surveyed in the Tenth District report price increases for their inputs in the 2 per cent to 4 per cent range during the past three months. Increases, however, are generally expected to be slower for the remainder of this year. Some purchasing agents feel that some suppliers have been taking advantage of the inflationary trend by raising prices beyond their actual cost increases.

On balance, materials inventories are perceived by purchasing agents to be at satisfactory levels. In only a few cases have there been any serious efforts to trim inventories due to inadequate sales. For the rest of the year, most industries plan to maintain their current levels of materials inventories.

Input materials availability is still not a major problem. Although lead times have lengthened, purchasing agents were in some instances forewarned by their suppliers and were able to allow for the extra

time in their purchasing patterns. Difficulties with materials availability are not anticipated for the rest of the year. The building materials industry is operating at full capacity, but other industries appear to be operating below that level. No bottlenecks were reported, nor are any anticipated to appear soon, in either plant or labor.

One head office director, whose firm is involved in the energy industry and related fields, reports the existence of a current shortage of gasoline in certain parts of the county, especially the upper Midwest. The shortage, which he describes as becoming critical and likely to tighten up further, is due both to strong demand and to some temporary refinery shutdowns. Tourist activity may be affected soon, and there is some possibility of a negative impact on agriculture in the early fall.

The dollar volume of retail sales is reported by Tenth District respondents to be substantially higher than a year ago, with particularly strong sales in the last three months for nearly all categories of goods. Price increases are reported to be only enough to cover wholesale cost increases and to maintain an acceptable margin. Inventory levels are more often viewed as satisfactory than as unsatisfactory. Inventory levels reported as unsatisfactory are generally regarded as too high in relation to current sales, and have led to special promotions—especially of non-durable goods. The majority of retailers view the remainder of the year with optimism, predicting strong sales for the upcoming fall season.

Two recently released U.S. Department of Agriculture reports indicate continued reduction in U.S. beef production. Despite increased numbers of cattle on feed and record high placements (up 12 and 9 per cent, respectively, from year-earlier levels) in the 23 major cattle feeding states,

marketings were also up substantially and no backlog of animals waiting to be sold was apparent. Furthermore, record numbers of heifers and heifer calves on feed will mean lighter average slaughter weights in future months.

Cattle inventory figures indicate that producers are still liquidating the nation's cattle inventory. Cowherd and replacement heifer numbers are both down from year-earlier levels. The nation's 1978 calf crop is expected to be off about 4 per cent from 1977 with a continued decline likely in 1979. These data—while heartening to cattle producers—suggest no relief is in sight for the consumer at the retail beef counter. In fact, average retail beef prices next year will likely be substantially higher than in 1978.

Most bankers contacted in the Tenth District reported that loan demand is strong. A number of bankers report heavy demands for real estate loans, especially in Colorado and Oklahoma. Construction lending is up from a year ago, with the strongest areas relating to government programs for multi-family housing for the elderly and for low income families. Agricultural loan demand has decreased everywhere in the District except Oklahoma, where borrowing by cattle ranchers is heavy. Loans for natural resources and energy development remain vigorous. Most bankers did not raise their lending rates during the past month, but they are being very selective in taking new customers.

Deposit growth is moderate at most banks contacted. Demand deposits are either flat or up slightly throughout most of the District. While bankers express concern about continued savings deposit outflows due to higher interest rates, consumer certificates and large negotiable CD's have increased more than enough to offset these outflows. Most bankers anticipate continued moderate deposit growth, but the cost of funds is expected to rise.

## ELEVENTH DISTRICT--DALLAS

Directors and businessmen surveyed this month report only minor changes in the strong rate of growth in economic activity in the Eleventh District. However, the outlook of the Directors is clearly pessimistic, as they see the high rate of inflation and tighter credit conditions leading to a sharp economic slowdown. A recent slowing in sales appears to have been caused by the oppressive effect of very hot weather on consumers' buying moods. Nonresidential construction activity, on the other hand, is increasing sharply. And home sales remain strong enough to keep mortgage rates high despite some improvement in savings inflows to savings and loan associations recently. Manufacturing activity continues to climb, although it is much less robust than a few months ago.

Directors of this Bank are of the opinion that a significant slowing in the national economy is in the offing, although they see the possibility of a recession as small. They indicate that given the anemic Government efforts to slow the rate of inflation, the rise in prices is likely to continue unabated. Interest rates are also expected to rise further, reducing residential construction activity and business fixed investment. The regional economy, however, is expected to fare better than the nation because of the influx of people and new firms into the Southwest.

Nonresidential construction is the fastest growing sector of the southwestern economy. Plant expansions and new plant construction by manufacturers are increasing sharply. Construction of power stations, public projects, and office buildings are also adding substantially to total contracts. The amount of office space under construction in the Dallas area

has more than doubled since February to nearly 6.5 million square feet. Residential construction activity remains strong, although higher prices and mortgage rates are cutting into sales of new homes.

The expansion in construction activity is hampered by shortages of cement, but surprisingly, prices have remained fairly stable. Recently, one major supplier attempted to raise prices but failed as other firms refused to follow suite. Imports of cement from Mexico are easing shortages in some areas, and there are several new cement plants under construction in Texas. Prices of other building materials in short supply are responding to the demand pressures.

Demand for real estate and construction loans is leading the rise in lending activity at commercial banks. Some of the recent real estate loans were to applicants turning to banks because S&L's were unable to meet their requests. Banks are becoming increasingly concerned about their liquidity positions. Loan volume at District banks is running well ahead of budgeted levels, and 20- to 30-percent gains in loan volume from year-ago levels are not uncommon. Substantial volumes of loans are being "laid off" to banks outside the District. Deposit growth, on the other hand, has been modest and not nearly fast enough to keep up with the growing demand for loans.

Deposit inflows to District S&L's continue to run behind those of a year earlier, although some pickup in savings inflows was noted recently. Sales of mortgages in the secondary market are still low, although some portfolio managers are discounting low-yielding mortgages in order to replace them with higher-yielding mortgages. Mortgage demand continues

strong, and mortgage rates remain near the 10 percent usury ceiling. Down payments of 25 to 30 percent are required by some S&L's in Houston and San Antonio, and other nonrate requirements remain restrictive. A few S&L's in the Dallas-Fort Worth area, however, are finding it necessary to reduce some of their lending requirements. One major S&L, for example, recently lengthened its commitment period after finding mortgage demand weakened beyond its expectations.

Manufacturers continue to complain of rising labor and energy costs. Most are able to pass these costs on to their customers, but some industries, such as copper producers, are unable to pass costs on because of weak demand. One copper company recently announced a price hike but predicts that copper prices will go down in the months ahead. Plant utilization in the industry is running between 70 and 75 percent of capacity, and new orders are expected to rise only moderately. Prospects are much better for other durable goods industries where backlogs of unfilled orders are increasing, and expansions in productive capacity are planned. Firms supplying the construction and drilling industries continue to do well, and sheet metal firms also report strong sales and a continuing rise in new orders. Outages of major Gulf Coast refineries have reduced available gasoline supplies, and as a result, are keeping pressure on wholesale gasoline prices.

## TWELFTH DISTRICT - SAN FRANCISCO

In most District states, retail sales are maintaining a 10 percent margin of increase over last year. Tight control of inventories is reported to have resulted in some loss of sales. Automobiles continue to sell well although there is a trend toward higher sales of domestic intermediates and lower imports in response to the decline of the dollar. Residential housing starts are declining throughout District states but nonresidential construction activity remains high. Demand for real estate is unquenchable but properties for sale continue in light supply. This summer's crop harvest has been bountiful and, with prices staying high, farmers have been able to recoup losses from winter weather damage. Feed lots are again running into a cost squeeze. An education administrator in Southern California sees a budget cutback of about 10 percent as a result of Proposition 13 which will effectively cancel community-oriented programs like child care centers and reduce the number of evening classes.

Retail sales continue robust in the Pacific Northwest, Nevada, and Arizona, but there has been some hesitancy in California as people try to take measure of Proposition 13. Consumers are uncertain about its ultimate effects on their paychecks and check-out counter tabs as well as tax assessments and rents. Nevertheless, in all areas, domestic automobiles have been selling well with standards currently outperforming compacts. Sales of imports, especially Japanese models, are off sharply due to price rises brought on by the decline in the dollar.

Retail sales of general merchandise are averaging about 10 percent higher than last year and most areas do not report any deceleration. In some areas where residential housing has levelled out, there is a boom in commercial building to house public and private support services and provide the infrastructure necessary to expanded communities.

Inventory-sales ratios are reported to be low, a situation which to a large extent is considered "normal" because of high inventory-carrying costs. However, there is some concern over a possible recession in the near future and this concern may be influencing operations. The result of this disposition on all levels of trade is to keep inventories relatively tight. One Director reported lost sales as a result of a low inventory policy.

In California, the one-month flurry of residential permit activity in June reflected a July 1 effective date for new structural energy requirements which are expected to add 15 percent to building costs. The basic trend is down, however, as it is throughout most of the Twelfth District. Real estate activity remains strong, but due to a lack of properties for sale and the general scarcity of rental units, the primary result is higher prices. The situation is exacerbated by the continued conversion of apartments to condominium units as a result of the threat of rent control, high cost of maintenance, and a high sales price/rental income ratio in most areas.

Around Seattle, the economy is experiencing a strong spurt due to the very large orders received by Boeing Company for its 767 airplane. Income, employment, sales and immigration are experiencing strong growth. Office space and housing are facing unquenchable demand which is expected to last at least through the end of this year.

In agriculture, excellent crops and high prices during the summer have allowed farmers to recover losses suffered earlier because of heavy spring rains. Regarding the livestock situation, the price of fat cattle has fallen, whereas the price of feeder cattle has risen. This tends to shrink the profit margin for feed lot operations. The prices of feeder-type grains--barley, oats, etc.--are still \$100 a ton or better. A squeeze on feed lot operators usually precedes higher prices at the retail counter, as rising feed-lot costs are

ultimately passed on to the consumer. Rising feed-lot costs that have developed over the past month and one-half are expected to influence retail prices in the winter.

A director who is a public college administrator in California has been trying to pin down the effects of Proposition 13 on higher education in his area. He projects a 15 to 20 percent reduction in the amount of resources available to his school. Projects such as child care centers will be eliminated and community service programs will be reduced to a minimum. Although reduction in over-all classes will be about 10 percent, most of it will affect part-time or evening classes. There has been an increase in early retirements and, since these teachers will be replaced by new lower-paid employees, the trend provides some budget relief. Teachers have been canvassed about doubling up on subjects and have been found flexible but not enthusiastic.