

CONFIDENTIAL (FR)

CURRENT ECONOMIC CONDITIONS BY DISTRICT

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SUMMARY*

The overall impression that emerges from this month's Current Economic Comments is one of no significant change over the past month in the business and financial situation. According to these reports, retailers in most Districts enjoyed a good to excellent Christmas selling season, although the sale of domestically produced autos continued weak. Retail inventories are generally at or even below desired levels, and manufacturing inventories are in line with sale expectations. Residential construction remains strong. There were further, albeit limited, indications of a strengthening of business plant and equipment expenditures. No significant disintermediation has developed, although savings inflows apparently have slowed down. Demand for bank credit, notably consumer loans, was strong.

Virtually all Districts report a good to excellent Christmas selling season at non-auto retailers, with business generally exceeding already high expectations. Sales thus are characterized as "fantastic" by some Boston respondents, and as breaking all records by Atlanta. A good to excellent selling season is reported by Cleveland, Chicago, San Francisco, New York, and Minneapolis and as substantially above expectations by Dallas. A number of Districts report continued brisk sales since Christmas, including Chicago, Philadelphia, Atlanta, Boston and San Francisco. Sluggish auto sales, however, are reported in about half of the reports. Among others, Chicago reports December auto sales to have been a distinct disappointment, while St. Louis and New York also note that such sales have been

* Prepared by the Federal Reserve Bank of New York.

less than expected. Auto dealers in the Dallas District look for sales of the 1978 models to exceed those of the 1977 models, but Cleveland characterizes prospects for new car sales and production as "highly uncertain". Continued strong sales of imported cars, however, are noted in Atlanta, Dallas and New York. Regarding consumer outlay on tourism, a good ski season is reported by Boston and San Francisco.

The high level of non-auto retail sales has apparently reduced retail inventories to desired levels, indeed in a number of cases to below such levels. Boston thus reports that strong Christmas sales has enabled retailers to work off any excess stocks that may have developed earlier, while Dallas reports inventory levels to have been drawn down to low levels at many stores. Similar sentiments are expressed by respondents in the Cleveland and San Francisco Districts. Chicago characterizes current retail inventory positions as on the "slim side", St. Louis as "trim", Minneapolis and New York as posing no problems, and Philadelphia and Richmond as consistent with sale expectations. Similarly, according to several reports, inventories at the manufacturing level are generally well balanced. Manufacturing respondents in the Kansas District thus reported their inventories as neither excessive nor inadequate, while Boston respondents felt inventories were unlikely to create problems. Philadelphia manufacturers plan to maintain their inventories at current levels, while St. Louis reports manufacturing inventories excluding autos to be generally in line with expected sales. However, the view that inventories are too high is widely held among manufacturers in the Richmond District.

Residential construction remains strong, according to those reports that comment on this sector. Atlanta perceives an acceleration in the pace

of such construction, led by single-family units but with quickening of the rate at which apartment projects are coming on stream as vacancies dwindle and rents climb. St. Louis reports home building to be strong, with recent home sales in some areas of the District the largest in several years for the winter season. Minneapolis notes that home building in its District has remained well above the previous record pace of 1972, and is expected to remain strong in the coming months, while housing experts in the Chicago District also believe home building will be strong again in 1978.

Regarding business capital outlays, Chicago reports that the demand for most types of capital goods has continued in a modest uptrend, and that a majority of purchasing agents in areas heavily emphasizing capital goods production expect improved conditions this year. Similarly, capital goods producers in the Cleveland District expect business to be as good or better this year than in 1977, with a sharp step-up in capital spending in the aerospace and communication industries. Respondents in New York and Cleveland note that currently ample capacity obviates the need for additional investment in the chemical industry, but Boston reports increased capital goods orders by that industry. Dallas reports that many oil field machinery and equipment manufacturers are expanding production facilities.

No significant change on balance appears to have occurred in manufacturing output and sales, which in general continued to advance. An improvement in the steel industry is noted by several banks, including Chicago, Cleveland and St. Louis. Philadelphia reports that the strike in the coal industry as yet has had little effect on the District's economy, although Richmond reports the strike to be a major factor in the District's

economy.

On the banking scene, no indications of significant disintermediation have emerged, although a low or slower rate of growth in time deposits and passbook saving accounts is noted by several Banks, including Richmond, Cleveland, St. Louis and Dallas. Concern was expressed by some respondents, however, that such disintermediation would occur should money rates rise much further. The demand for credit continues strong, particularly for consumer and real estate loans.

FIRST DISTRICT - BOSTON

First District respondents are generally pleased with the present economic situation. Manufacturers are experiencing growth ranging from moderate to very strong. Christmas retail sales were very good. Inventories seem to be under control and the inflation rate appears to be holding steady. The only negative notes are concern about the continued weakness of foreign economies and worry over the possibility of higher short-term interest rates.

Christmas retail sales in the First District were very good. Several respondents described them as "fantastic." Moreover, indications of after-Christmas sales are also favorable. The head of a large department store chain who was previously worried about a widespread inventory buildup now feels that no substantial inventory correction will be necessary. The strong Christmas sales enabled retailers to work off any excess. Consumers also appear to be spending freely on tourism. The ski industry in northern New England is off to a very good start. Volumes are well above last year, which was a record. One banker did report that the demand for consumer retail loans is tapering off. However, he felt that this was to be expected given the unusually high volumes of recent months. The demand for auto loans was flat.

Most manufacturers contacted are continuing to see an increase in sales. Even in Connecticut where several firms with special problems had extensive layoffs, manufacturing production was up and employment held steady. Sales of household products, particularly small appliances, have been doing well. Auto products have also been moving briskly and although growth in 1978 is not likely to be as strong as in 1977 some gains are still expected.

A supplier of capital goods to the chemical industry reported a sharp pick-up in his order rate. International prospects, however, are a source of uncertainty. A chemicals producer expressed concern about the weakness of the overseas market: recent sales in Europe were very disappointing.

None of the manufacturers contacted felt that inventories were likely to be a problem for them. Price increases have been pretty much as expected and no one foresees any difficulty obtaining materials or fuel. One manufacturer, however, was quite worried about short-term interest rates. This firm is a frequent borrower of working capital, and while they are not experiencing a problem now they are very concerned about the future.

Commercial banks in the First District report good deposit inflows although one banker expressed concern about disintermediation should market rates increase more than another 50 basis points. Consumer loan demand continues to improve and is expected to be strong throughout 1978 with bank credit supplying an increasing share of corporate borrowing.

Professors Eckstein, Houthakker, Samuelson, and Tobin were contacted this month. All but Tobin expressed reservations about intervention on behalf of the dollar. Eckstein feels avoiding getting locked into fixed exchange rates is of singular importance. On the other hand, when our major creditor, Saudi Arabia, insists that something be done, token intervention may be a wise near-term political expedient. Houthakker believes intervention may occasionally be necessary when market conditions become disorderly as may have been the case in the early days of the new year. Further intervention, however, is not necessary and not in the best interests of the United States. Lower import prices would help meet Germany's and Japan's concern about inflation and provide them with more elbow room to pursue expansionary policies.

Although declines in the dollar do contribute to our inflation, the magnitude of the impact so far is one we can live with. Unlike 1972 and 1973, the rise in the prices of our imports have not been accompanied by sharp increases in the price of exported goods. Tobin does not object to short-run intervention to stabilize irrational day-to-day speculation but does oppose trying to peg the exchange rate. Tobin doubts that the dollar would be overvalued if Germany and Japan were operating at reasonable levels of capacity, and questions whether it is overvalued anyway. Recent declines reflect portfolio shifts by OPEC investors that have little to do with the fundamental value of the dollar. A policy which would enhance confidence in the economic recovery and boost the stock market would help to restore the capital inflow.

Eckstein believes the long-run monetary growth targets should be left unchanged. Houthakker urged the Fed to stick to its target range; stabilizing M1 growth at the 7 percent rate recorded over the past year would be a satisfactory policy. Tobin reiterated his view that quantitative targets should be set for GNP, rather than monetary, growth. Monetary policy should aim at a 10 to 13 percent growth in nominal GNP.

With the exception of auto sales, Samuelson feels economic data are favorable. The tax cut proposal will act like a safety net--adjusted down if the economy proves stronger than expected and augmented if the economy is weaker. Samuelson is concerned that preoccupation with the stability of the dollar be used as an excuse of deliberate acceptance of a growth recession. A real growth target of at least 4 1/2 percent would not create demand pull inflationary pressure.

SECOND DISTRICT--NEW YORK

Business activity remains mixed in the Second District, according to directors and business leaders, but the outlook is viewed more favorably than in recent months. Retailers throughout the region apparently experienced an excellent holiday season, and their inventories are now judged at satisfactory levels. Although some hesitation followed settlement of the two-month selective dock strike, the outlook for shipping is now characterized as strong. There are also some scattered reports of increases in capital spending in the district. Domestic auto sales remain depressed, however, although some dealers are optimistic that activity could strengthen considerably in the spring.

Virtually all major retailers contacted in the Second District were elated over the strength of buying during the holiday season. Sales at the major department stores apparently at least matched or in some cases far exceeded expectations, which had already been high. New York City sales were especially strong, with some outlets claiming their best holiday performance in at least several years. While some retailers reported a large amount of discounting and promotional activity, few indicated that this was more than normal for the period.

Information on post-holiday sales is sketchy and conflicting. Some respondents reported that sales were holding up very well in early January, while others talked of a post-holiday slump. In any case, all retailers contacted indicated that inventories were now on target or only

slightly above target. None viewed their inventories as a problem given the volume of business they experienced in December.

While department store sales have been strong in the district, according to most respondents, sales of domestically produced autos continue to be depressed. Dealers report that inventories are not moving because of price resistance and dissatisfaction with the new models. However, there appears to be growing optimism among dealers that this is simply a question of deferred buying, since a spring upturn is common when there has been a slow winter.

By contrast, foreign auto sales have been very strong, substantially above last year's level and ahead of all projections. A spokesman for dealers of a major foreign compact reported that, since the introduction of the 1978 models, inventories have been insufficient to meet demand, and there has been a backlog of orders. Although there has been a sharp increase in price, largely as a result of the depreciation of the dollar, there is no evidence of any price resistance as of yet. Instead, customers apparently intend to hold their newly purchased autos for a longer period of time, as they are buying more expensive options. These dealers believe former large car owners are switching to smaller cars but prefer the proven quality of the foreign models to the unknown performance of the new domestic small models.

In other sectors of the district economy, respondents also continue to paint a rather mixed picture. A Buffalo director indicated that the outlook for the chemical equipment industry is not good. The situation in the power equipment industry, however, appears brighter due

to the general need for more power plants, but the long time frame for such construction makes specific predictions difficult.

A spokesman for a metals producer in the district reports that their copper and brass business is still strong. This is expected to continue for the next two months and reflects, in part, strikes at competitors. Although aluminum mill production has been good, demand for ingots is spotty. Demand for consumer metal products, on the other hand, is expected to continue to be strong through spring.

A spokesman for an upstate forge reports a mild increase in orders. He expects a steady level of orders through the first half of the year with most as replacement orders rather than net investment. With no expectations of bottlenecks in production capacity or shortages in labor or materials, he believes 1978 will be a good year.

The New York telephone company is projecting an increase in volume above last year's rise, according to one of the directors. He also indicated that the telephone company is planning to increase expenditures on new construction by approximately 10 percent over the 1977 level. Another director reported a substantial increase in capital spending plans by other companies in the Second District for 1978.

Contrary to initial impressions, the shipping industry in the Second District did not rebound immediately following settlement of the selective dock strike at the beginning of December. However, an executive with a leading steamship company reports that business now looks good and that his outlook for 1978 is very optimistic.

THIRD DISTRICT - PHILADELPHIA

Indications from the Third District are that economic activity continues to expand unevenly. Respondents to the January Business Outlook Survey say that manufacturing activity is essentially unchanged for the third straight month, but retail sales are up for the fourth month in a row according to executives in that sector. Looking to the future, both manufacturers and retailers are anticipating expansion. Area bankers say that business borrowing is up, but still generally sluggish. They too look for expansion over the next six months. The nationwide coal strike is having little effect on the District economy at this time, but shortages could develop if miners stay off the job through February.

Manufacturers responding to this month's Business Outlook Survey say that general business conditions are only marginally better than last month, indicating that the slowdown that started in November is now in its third month. In terms of specific indicators, employment and the average work-week are unchanged, continuing a three-month trend. New orders and shipments are higher in January, but inventories are down for the first time since early last year.

The continued sluggishness appears to be having an effect on manufacturers' expectations regarding the next six months. While producers are still bullish overall, fewer are looking for improvement in the first half of 1978 than in previous months. New orders and shipments are expected to pick up, but again by a smaller proportion of respondents than in the recent past. At the same time, inventories are projected to remain at their current levels. Despite this dampened optimism, however, manufacturers still anticipate some

gains in employment over the next six months. Thirty percent of the respondents say they plan to add to their payrolls by July, and 21 percent anticipate a longer workweek by that time. Capital spending plans have not been diminished either. Increases in expenditures on plant and equipment are planned at slightly more than one-third of the sampled firms--about the same as last month.

Comments by a director of this Bank are consistent with these reported expectations. He sees the outlook for 1978 as only moderate, and claims that capacity utilization in his particular industry won't approach the levels necessary to induce investment.

Price increases in the industrial sector appear to be picking up steam. Over half of the executives surveyed this month report higher prices for inputs, and about one-fourth say they're getting more for the goods they sell. As for the future, three-fourths of those polled anticipate paying more for raw materials by July, while about half expect to hike the prices of their finished products.

The nationwide coal strike is having little impact on the Third District economy. Although about 18 percent of all bituminous coal miners in the U.S. are employed in Pennsylvania, only about 4 percent work in the Third District. Moreover, utilities and steel producers, the major users of coal, have stockpiled the fuel so that no shortages have as yet developed. According to a director of this Bank representing the energy industry though, with the strike now in its sixth week, about half of those inventories have been depleted. Should the strike last longer than 45 more days, supply may become a problem as holders of inventories try to spread a limited stock over a longer time. Coal officials contacted had no opinion on the expected duration of the work stoppage.

Sales at area department stores are higher again in January according to retailing executives. Current dollar sales, reported to be between 8 and 21 percent above January '77 levels, are outpacing expectations by about 5 percentage points in most cases. Downtown Philadelphia and suburban stores are doing equally well.

Merchants appear to be optimistic about economic conditions over the next six months, and look for sales increases of 5 to 12 percent over year-earlier levels. Consequently, most retailers say that inventories are up, but that these higher levels are consistent with the expected higher sales volume.

Commercial bankers in the area say that business loan demand is about 4 percent higher than it was at this time last year. This is generally at or below planned levels. Bankers note that although borrowing by local businesses is "as expected," the national market continues to be depressed. They continue to cite alternative sources of funds and uncertainty about future economic developments as the major causes of sluggish loan demand. The demand for the consumer loans remains strong.

For the longer term, bankers foresee "moderate" growth in C&I loans. They expect July loan volume to be 7 to 9 percent above the mid-1977 level.

The prime rate at every bank contacted is at 7 3/4 or 8 percent. It is generally expected to increase to about 8 1/4 percent by mid-year. Contacts say they have noticed some disintermediation owing to higher short-term rates, but that it is not now a problem. One banker noted that when interest rates started to rise, some depositors shifted to higher-rate, longer-term certificates and are now locked into those deposits, and claims that this is one factor that has helped to keep disintermediation to a minimum.

FOURTH DISTRICT - CLEVELAND

Nonautomotive retailers and steel producers in the Fourth District are increasingly optimistic over sales prospects. Auto suppliers are skeptical that domestic new car sales will pick up much from recent rates. Steel production will be boosted this quarter partly because of price hedge buying. Capital goods producers still expect a good but not boom year. Continued slow growth in deposit flows is noted by banks and thrift institutions.

Nonautomotive retailers describe sales during December as excellent and generally above expectations. Some department store officials had expected year-over-year gains of 9 to 10 percent, but actually recorded larger gains. An economist associated with a large department store chain reported even larger gains for GAF merchandise. These retailers are increasingly optimistic in view of the sustained rise in sales since last fall, but also point out that by spring consumer preferences can again shift from general merchandise to automobiles. Retailers are also pleased that sizable increases in sales have pared inventories.

Prospects for new car sales and production are highly uncertain. Two contrasting scenarios have surfaced: one views the reduced pace of sales as temporary and associated with down-sizing of intermediate cars by GMC; the other views the softening as a result of consumer substitution of other goods for automobiles. According to the former, as expressed by an economist with a major auto producer, consumers are either buying smaller

GMC cars or are holding on to their cars a year longer. If sales in January do not pick up, auto producers will sharply cut back production schedules for the balance of this quarter. Some GMC auto dealers confirm consumer disinterest for even the highly popular Oldsmobile Cutlass, which one dealer described as smaller, lighter and 6 percent lower in price than the 1977 models.

Auto suppliers, especially steel and tire producers, have not experienced major setbacks in orders from auto producers, except from Chrysler and AMC. A major tire producer reported, however, that GMC's January projection of car production this quarter was shaved 100,000 units to 2,485,000 cars. This tire maker has been skeptical of sales and production projections by auto producers and has pared the estimate to 2,250,000 million this quarter. They expect total new car sales of 10.7 million this year and feel a comeback in auto sales is unlikely because of the ample stock of new cars over the past few years and the rapid build-up of consumer debt.

The turnaround in steel operations that began last month has accelerated under the impetus of price hedge buying. The February 1 increase in steel prices caused the bulge in orders for January deliver. According to one steel economist, orders for February and March shipments have not fallen as they usually have done after a price increase. The steel price increases scheduled for February and March have also had the effect of ending the most recent phase of steel inventory liquidation. First quarter steel shipments are expected to increase about 10 percent from the fourth quarter 1977. Even at this higher level of shipments and production, however, industry profits will probably be negligible this quarter.

Generally, steel economists were noncommittal about reference pricing of steel, pending additional information. One executive with a major steel producer, however, views the announced trigger prices as low; and an industry economist is skeptical that these prices will result in much of a rollback in steel imports. Another source indicated that the talk about reference pricing may have deterred some users from placing foreign orders beyond the first quarter of 1978. If anything, reference prices are more likely to have an adverse effect on European steel producers than on the Japanese, who still have a quality and price advantage over most steel producers.

Capital goods producers expect business this year to be as good or better than 1977, although there is still little sign that spending for new plant capacity is accelerating. Exceptions are in technically oriented industries, such as aerospace and communications, where producers indicate a sharp stepup in spending for new capacity. A communications and printing press producer has been experiencing an order rate of about \$1 billion compared with sales of around \$900 million and will boost capital expansion this year. An aerospace and electronics producer expects to boost capital spending by 40 percent from last year. On the other hand, a medium-sized chemical producer reported that they had no additional need for capacity over the next few years in view of softness in prices, ample capacity, and completion of expansion programs that were begun a few years ago. Rubber producers will accelerate capital spending this year because of need for additional radial tire capacity to replace obsolete facilities and to improve productivity. A large machinery producer reported the excavator machinery

business is still slow to recover and that increased orders for machine tools are replacements for existing inefficient equipment with computer-controlled machinery.

There is no sign of early settlement of the coal strike. More than a third of the industry in Eastern Kentucky, one of the largest coal mining centers in the country, is shut down, and about 90 percent of the mines in Ohio, West Virginia and Pennsylvania are down. A director, who describes the strike as bitter, does not expect a settlement before mid-February, although there will be growing pressure to end the strike because pensions funds will be depleted. Another source associated with a major coal producer expects the union may drop the right-to-strike issue in return for increased contributions by mine operators to the health and welfare fund.

Banks and thrift institutions report no signs of disintermediation, although growth in time deposits and passbook savings accounts has slowed. A large S&L is concerned that outflows from passbook savings accounts could occur if yields on 3-month Treasury bills exceed 7 percent. S&L's have been increasingly active in the secondary mortgage market to support the high volume of mortgage loans. One association reported that it sold over \$50 million of mortgages in 1977, or 10 percent of its portfolio, in the secondary market. Lenders, builders, and producers of home maintenance and building materials continued to be cautiously optimistic over prospects for new housing starts in 1978. One director expects new starts at 1.8 million units this year.

FIFTH DISTRICT - RICHMOND

The pace of Fifth District manufacturing activity apparently showed little change in December, judging from responses to our latest survey. The volume of new orders and backlogs were down somewhat while shipments were essentially unchanged. Inventories also showed little change, a minor expansion of stocks of materials being offset by a comparable decline in finished goods. There remains, however, a widespread view among manufacturers that current inventories are above desired levels. Retailers' expectations of a strong Christmas selling season have apparently been fulfilled. Total sales as well as relative sales of big ticket items increased in December. Concerning longer term expectations, manufacturers' outlooks have improved over the past month, but a majority of the respondents still foresee little change in the level of business activity over the next six months. The apparent lack of progress in the coal industry negotiations suggests continued sluggishness in the overall level of Fifth District activity in the near term future as supporting industries continue to cut back operations and personnel.

As in December, our January survey of manufacturers showed considerable variation in the performance of individual respondents. There is little indication from the survey of the present direction, if any, of the District economy. One change since last month is that the weaker responses are now more heavily concentrated in the textile industry and the fibers component of the chemicals group. Otherwise there is no discernible pattern in this month's responses. Inventories held by District manufacturers were virtually unchanged, but the view that current levels are excessive remains common. Employment and weekly hours worked both declined in December according to survey respondents.

Prices, particularly prices paid, continued to rise across a broad front.

In the retail sector activity was broadly higher in December than a month earlier. Respondents to our survey were unanimous in reporting increased sales and a majority also reported increases in the relative sales of big ticket items. Inventories at retail showed little change and are generally in line with desired levels. Employee compensation, in terms of average hourly earnings, rose over the month, but responses suggest no change in other prices paid or received by retailers.

District manufacturers express somewhat greater optimism than in recent surveys and expectations in general now seem more positive than at any time since mid-summer. Approximately one-third of the manufacturers surveyed now expect the level of business activity nationally, locally, and in their respective firms to improve over the next six months. Retailers, on the other hand, apparently expect little or no change in the level of activity over that period.

The UMW strike remains a major factor in the Fifth District economic picture. Indications are that somewhat in excess of 80,000 Fifth District employees are out of work as a result of the strike, although this number has not increased since the early days of the work stoppage. Significant additions to this figure are unlikely over the next month. Should the strike extend beyond that point, however, a second round of layoffs, primarily of coal users, is likely unless other sources of coal are found.

Credit at large Fifth District banks has expanded moderately during the past several weeks, with loans to consumers and business leading the expansion. At the same time inflows of time and savings deposits net of negotiable CD's have been small. Holdings of large negotiable CD's, however,

have risen substantially. These funds have increased every week for the past several months. Consumer credit extended by banks has risen steadily since November, reversing its October lull. Real estate loans, on the other hand, continue seasonally weak. Half of the banks reporting on the Fifth District survey of changes in lending practices confirm that demand for commercial and industrial loans has increased moderately over the past six months. Only two of the twelve reporters, however, expect such demand to continue to expand over the next three months. Both the price and non-price terms on business loans have firmed recently, as District banks exhibit a reduced willingness to enter into term loan arrangements.

The District's cash farm income during January-October 1977 was down 4 percent from a year ago, reflecting the drought-reduced crop output and sagging grain, soybean, and cotton prices. Crop receipts were 10 percent under the year-earlier period, while livestock receipts were up 2 percent. Nationally, total cash farm receipts were about 1 percent under the year-ago level.

SIXTH DISTRICT - ATLANTA

December was a banner month for consumer spending; auto purchases held up better in the Southeast than in the nation. Banks have realized strong gains on both sides of the balance sheet, but at S&Ls, the gap between loans and deposits has widened. Housing demand continues to climb. Rising agricultural prices have brought some relief for the farmers' plight, and the strike has had little impact. Job gains continue despite strikes and layoffs. Businessmen are relatively optimistic about economic conditions in 1978.

By almost all accounts, December retail sales broke all records and a brisk buying pace carried through the week after Christmas. Retailers commonly estimate year-to-year sales gains at 15-20 percent. Two directors commented that luxury items had been moving particularly well in their areas. One retailer who had been concerned about his large inventory now complains that inadequate stocks restrained his sales. Only in the coal-mining areas of northeast Tennessee did sales fail to show a year-to-year advance.

Sales of new domestic-made cars seem to have held about even with last year in the last few weeks of 1977. Dealer inventories have reached "ample" (but below national) levels. Designations of the best-selling models vary too widely for a neat characterization. In Jacksonville, a record number of imports were unloaded last month. Truck sales continue to surge; both Chrysler and Ford recorded all-time peak truck sales in their southeastern zones last month.

Bank deposit inflows have strengthened after a brief slowing; large-denomination CDs have accounted for much of time deposit growth. Exceptionally strong gains in bank lending have been broad-based, inducing some banks to reduce their securities holdings. Stricter adherence to usury laws has reduced bank earnings in Tennessee. Mortgage rates at S&Ls have held a pretty even keel, though lending activity remains heavy. There are indications that sources of funds are tightening in places: Central Florida S&Ls are advertising certificates at maximum rates (atypical in that state), and Atlanta associations are both advertising and offering premiums again.

The pace of residential construction has continued to accelerate through the off-season, still led by single-family homes. Demand for existing homes has mounted. Apartment projects are coming on stream at a quicker but moderate rate as vacancies dwindle and rents climb.

The first round of annual tallies of nonresidential construction outlays shows surprisingly strong (30-75 percent) gains in some of the smaller cities. Planning has progressed to the initial stages of construction on several major industrial projects (representing several hundred million dollars) announced earlier. On the negative side, Offshore Power Systems of Jacksonville ordered a 30-day halt (with possible termination) on \$75 million of construction when the State of New Jersey, its only customer, extended the delivery date on its order by three years.

Stronger export demand has lifted prices of farm products, especially grains, improving farm incomes somewhat from badly depressed levels. Recent loan applications suggest that Mississippi farmers have maintained their living standards through a disastrous year, piling up

substantial unpaid debts. The effects of the much-publicized farmers' strike have been limited to sporadic interruptions of marketings. Livestock auctions in Georgia and Alabama closed briefly. Picketers at meat-packing plants convinced few truckers to hold their cargoes, but slaughter volume was reduced temporarily. Late December explosions at several grain storage facilities are thought to have been caused by unusual atmospheric conditions, combined with high concentrations of dust, rather than sabotage.

District employment has risen steadily despite the interruptions of strikes. Most of the disputes which have troubled the labor scene for the past few months (including the massive Lockheed strike) have now been resolved. The coal strike, however, has begun to afflict retailers, banks, and small coal producers in northeast Tennessee. The impact of a recent large layoff in central Florida will be more than offset by new jobs provided by industrial expansion; a new CETA grant to Mississippi will furnish almost as many new jobs as will be lost to extensive layoffs by Ingalls Shipyards.

There is no uniform consensus among businessmen or area economists about the prospects for 1978. Few are totally pessimistic, but most express some apprehension about inflation, government regulatory policies, energy developments, and the minimum wage. Tennessee bankers are particularly concerned with the outcome of a March constitutional referendum on the usury ceiling. The majority of business leaders expect the economy to improve at least as rapidly in 1978 as it did in 1977. They generally anticipate better-than-national growth in their own industries or locations, citing such potential stimulants as reviving population growth, continuing housing expansion, rebounding nonresidential investment, and/or increasing tourist inflows.

SEVENTH DISTRICT - CHICAGO

Most economic sectors in the Seventh District still appear to be expanding, and sentiment is generally favorable that growth will continue into the second half of 1978. Production schedules for autos and farm equipment have been reduced, however. Retail sales of general merchandise have been very strong. Inventories are generally on the slim side. The slow but steady uptrend in total capital outlays is continuing. Favorable weather, until this week, has permitted outdoor construction activity to continue later this winter than last. Mortgage credit terms are tightening moderately.

Virtually all general merchandise retailers report that sales exceeded optimistic budgets, not only in the Christmas season, but since Christmas as well. Inventories are "on the slim side." January "clearance" sales have emphasized special purchases rather than markdowns of regular stock. Sales of most lines have been at high levels, with home furnishings, including appliances and furniture, especially good. Consumers have used credit freely but "with prudence." A University of Michigan survey showing consumer confidence "at a two-year low" in December baffles local retail analysts.

Large retailers expect their selling prices to average somewhat more than 4 percent higher in 1978, about the same as the rise in 1977, with soft goods up more than hard goods. Purchasing managers for industrial and commercial companies expect the prices they pay to rise 6 to 7 percent on average in 1978, also about the same as in 1977. Prices of some commodities have been held down by stiff competition. But utility rates are 10 percent or more above year ago levels, while costs of insurance, transportation, and professional services probably have increased even more.

Auto companies have been cutting production schedules for the first quarter. Sales in December were a distinct disappointment, particularly for the new down-sized intermediates. Sales of heavy trucks also have slowed.

A number of layoffs have been announced in the district's important farm equipment industry, with at least one tractor plant closed for the whole month of January. Sales of farm equipment had been sharply below year ago levels long before the widely publicized "farmers' strike."

The December survey of the Milwaukee purchasing managers shows that 46 percent expect their business to be better in the first quarter than in the fourth quarter, as opposed to only 10 percent who expect it to be worse. For the second half of 1978, 58 percent see business better than in the first half, and only 5 percent expect it to be worse. This is significant because of the heavy emphasis on capital goods production in the Milwaukee area. Also, a high proportion report that their companies' capital expenditures will be higher in 1978. Finally, the proportion reporting higher output and orders was larger in December than in November. Inventories were reduced on average in both months.

Demand for most types of capital goods has continued in a modest up-trend. Foreign demand for US equipment has remained sluggish, however. Among the most confident firms are producers of sophisticated machine tools, often used in mass production processes. The auto industry continues to dominate these orders, but demand from other industries also has improved.

Steel companies expect an improvement in their shipments in the first quarter because of restrictions on imports, low user inventories, and further gains in total usage. However, auto producers probably will reduce their orders for steel. While total steel imports into the US were up about one-

third last year, imports into the Great Lakes area rose by over three-fourths. Many of the vessels waiting to exit the Seaway after the scheduled closing date of December 15 had brought in European steel and had delayed their sailings as they sought cargos for the return voyage.

Relatively favorable weather in December and early January permitted private and public construction projects to continue in a period when outside work had virtually ceased last winter because of severe cold and strong winds. Four new office buildings totaling 3.8 million square feet are underway (or soon will be) in Chicago's Loop, scheduled for completion in 1979. Over 5 million square feet of office space is said to be vacant in the Loop, but large blocks of top notch space are not available.

Most housing experts believe that homebuilding will be strong again this year. Prices are still rising at a 9 to 10 percent pace. Shortages of materials, particularly insulation and sheetrock, are not likely to be resolved in 1978. Limited availability of developed lots, with sewer restrictions a large factor, has held back plans of some builders. Some of the largest Chicago area S&Ls recently raised their basic rates on 80 percent home mortgages from 8.75 to 9 percent. Moderate further tightening of rates is expected. Opinions vary as to whether availability of mortgage funds will limit construction this year. The main question mark is the extent of disintermediation, already noted by some lenders.

Permits for apartment units in the Chicago area in 1977 were about double the level of 1975. Nevertheless, apartments comprised only 34 percent of all units, compared to 58 percent in 1971 and 1972. Suburbs reporting the largest increases in permits in 1977 are generally 30 miles or more from the Loop, and often 6 to 7 miles from public transportation.

EIGHTH DISTRICT -- ST. LOUIS

Business activity in the Eighth District continued to rise in late 1977, and businessmen generally expect further gains in 1978. Retail sales have registered moderate gains in recent weeks, although automobile sales by some dealers have been less than expected. Retail inventories are generally at a "satisfactory" level, but stocks of some types of cars were reported to be greater than desired. Home construction and sales continue strong for this time of year, and overall manufacturing activity is advancing. In the financial sector loan demand is generally strong. Savings and loan institutions report inflows of savings are smaller than a year ago, and with strong demand for home mortgages, mortgage interest rates are beginning to inch upward.

Consumer spending has continued to advance from year ago levels, and retailers are generally optimistic about sales prospects for 1978. On the basis of limited information, St. Louis department stores made only modest sales gains during the recent Christmas season, but reports from other areas of the District indicate larger gains than in the St. Louis area. Durable goods sales are mixed. Home appliance sales continue up, while automobile sales have leveled off. Automobile sales have declined in the Memphis area, probably reflecting a ruling by the Tennessee Supreme Court which limited interest rates under the state usury law to a 10 percent maximum.

Inventories at the retail level are reported to be "trim." Even at department stores, where sales gains in the Christmas season were only modest, inventories are not considered to be a problem. Inventories of some automobile makes, however, are considered to be above desired levels. Other

manufacturing inventories are generally in line with expected sales.

Demand is strong for most types of loans, including real estate, consumer, and agricultural loans. Overall, business loan demand at commercial banks, however, has not increased much in recent weeks. In December net inflows of consumer-type savings deposits at banks and savings and loan associations were well below year ago levels. However, sizable increases have occurred in large negotiable certificates of deposit. Upward pressure on home mortgage interest rates is apparently developing. One large savings and loan association in the St. Louis area recently increased its lending rate on an 80 percent loan to 9 percent from the 8-3/4 percent rate which had prevailed for several months.

Manufacturing activity generally continues to advance. Manufacturing of building materials, appliances, heating equipment, recreational equipment, paints and coatings, paper and boxboard, and hospital supplies are among industries reporting sales gains. A steel industry representative noted that steel orders have unexpectedly accelerated in recent weeks, reflecting prospective anti-dumping measures, and continued overall improvement in steel demand. A major chemical firm, however, notes mixed sales among its product lines, and farm equipment sales are reported to be sluggish, reflecting the relatively low farm incomes of last year.

Home building remains at a high level. Recent home sales in the St. Louis and Memphis areas were reported to be the largest in several years for the winter season. Reports from Memphis also indicate a recovery from the overbuilding which occurred in 1973-74. Due to strong home sales and sizable backlogs of orders, most builders are not laying off workers as normally occurs at this time of year.

Fall wheat plantings are estimated to be down substantially in the District. Wet weather in Missouri last fall hampered planting operations and wheat acreage was estimated to be off 45 percent from last year. Wheat acreage is also reported to be down substantially in Tennessee.

NINTH DISTRICT - MINNEAPOLIS

As we enter the new year, most indicators of economic activity in the Ninth District remain strong, and the near-term outlook is generally favorable. Declines in unemployment, strong retail sales, and booming residential construction were reported in 1977 and are expected to continue, perhaps at moderated paces, in early 1978. Large crop carryovers are expected to continue downward pressure on commodity prices. Despite historically high loan-to-deposit ratios, Reserve Bank directors are not aware of serious liquidity problems at district agricultural banks.

Employment

The district's employment picture is considerably improved from a year ago. The fourth-quarter unemployment rate of 5.2 percent (based on October-November data) is more than a full percentage point below last year's 6.3 percent. Improvement is reported throughout the district, including the chronically high unemployment area of Michigan's Upper Peninsula. Even in that region, unemployment in a few counties is less than 5 percent.

Reserve Bank directors generally see a favorable employment outlook for the first half of 1978, ranging from "very strong" to "very stable." Areas expecting continued strength include western Wisconsin, South Dakota (except for some weakness in ag-related industries), portions of the Upper Peninsula, and central Minnesota. "Stable" areas include metropolitan Minnesota, North Dakota, and eastern Montana. A banker sums up the outlook for the large industrial areas by suggesting that unemployment will continue to decline but at a somewhat slower pace as the economic

recovery progresses. Only two areas in the district may have employment problems: western Montana, where public employment is being reduced and the wood product industries are softening, and Sault Ste. Marie, Michigan, where the closing of an air base is having a severe impact on the local economy.

Retail Sales

Retail sales were strong throughout the district in the last quarter of 1977, according to our directors. All directors report that Christmas sales met or exceeded retailers' high expectations. A few directors describe seasonal sales as "strong," "pretty good," and "remarkably good." Severe weather in North Dakota reduced sales from what they otherwise would have been, but even there, retailers are described as "happy."

Our surveys are consistent with these observations. Some retailers are reporting sales for December as 10 to 30 percent over a year ago. Retailers with outlets in rural areas found sales gains there about the same as in the metropolitan area.

Neither our directors nor our surveys uncovered any significant retail inventory problems.

Residential Construction

Homebuilding has remained well above the record annual pace set in 1972. For the first ten months of 1977 cumulative housing permits were 31 percent higher than the year-earlier level, which was 34 percent higher than in 1975. Data through October do not yet indicate a slowdown, although some directors have previously suggested this might happen. In any event, loan commitments outstanding at district S&Ls rose steadily

throughout 1977 and in November were 25 percent above the year-ago level. Consequently, we expect homebuilding to remain strong in the district, at least during the first quarter of 1978.

Agriculture

According to Reserve Bank directors, there is little evidence to suggest that the farm strike has done anything more than generate some publicity. In Montana, some small marginal crop farmers apparently are participating, but ranchers are not. A director representing the food industry notes that his firm has been buying corn from farmers throughout December, which does not represent a withholding action. One director described the farm strike as a "nonevent."

With the dramatic turnaround in weather conditions, total crop production in 1977 easily exceeded that of 1976. Soybeans were up 80 percent and corn 75 percent. Wheat production declined about 10 percent but only because of a 13 percent reduction in plantings. The resulting low commodity prices not only have depressed current farm receipts but also have built up a large carryover of grain which will continue to exert downward pressure on market prices.

In general, our directors have observed that government crop deficiency payments are improving liquidity situations at rural banks, but how much is still hard to say. Apparently, some of the payments are lower than anticipated and are coming in a little slower than expected, so directors have yet to form any judgments. Several directors note that there might be some complaints about ag bank liquidity or that loan-to-deposit ratios might be high in historical terms, but they are not aware of any serious liquidity problems.

TENTH DISTRICT--KANSAS CITY

Reports of business and financial conditions in the Tenth District point to continued economic expansion. Although prospects for improvement in farm income are not that bright, the winter wheat crop looks good and prices of agricultural products have regained some strength. Purchasing agents for major manufacturers in the District expect the year to be good for business. These buyers are comfortable with their current inventories of materials, and they are neither experiencing nor anticipating a general acceleration in the prices of materials nor significant problems in maintaining stocks at desired levels. District bankers report a sharp increase in loan demand and a good increase in total deposits. These bankers do not expect deposit growth to keep up with loan demand, and they forecast sharp disintermediation if short-term interest rates rise to 7 per cent.

Purchasing agents in various types of businesses throughout the District report little change in the lead times for the items they buy, with a few exceptions. The exceptions are primarily in steel, especially sheet and plate, where some stretching out of lead times is being experienced, but not by all buyers. The purchasing agents who are finding steel harder to obtain attribute the change to layoffs in the domestic steel industry, and to less "dumping" by the Japanese. Some aluminum materials also are becoming somewhat less readily available, according to a purchasing manager for a manufacturer of small airplanes. A competitor, however, says he is having no problems getting aluminum.

The purchasing agents are generally optimistic about prospects

for sales by their firms this year. Their levels of inventories of raw materials are neither excessive nor inadequate, say most buyers, who describe their stocks with phrases such as "ideal," "just right," "where we want them," and "according to plan." Most buyers expect the prices of materials to rise at about the rate of inflation. Certain petroleum-based chemicals and related products are expected to go up somewhat faster in price. Polyester fibers, used by two major rubber manufacturers, and a solvent, used by a paint manufacturer are two of the items expected to show sizeable price increases soon. A manufacturer of furniture hopes to see an end to the frequent price increases, totaling 30 per cent in 1977, on plywood and particle board.

Following a 3-month rebound, farm prices have once again reached the levels of last July due largely to stronger markets for hogs, cattle, and corn. In December, farm prices were only 1½ per cent above year-ago levels, which explains why retail food prices were not a particularly troublesome issue in 1977. Of course, it should be recognized that the stability in food prices has come at the expense of the farmer who has been confronted with serious cash flow problems and depressed incomes for most of the last 2 years as commodity prices have generally fallen. Moreover, although adjustments are occurring, most of the evidence suggests that income levels are not likely to show much improvement in the year ahead.

A recent report on the seeding of the new winter wheat crop shows that acreage nationwide will be down about 14 per cent from 1977 levels. If the 1.3 billion bushel projection is realized, 1978 production will be off 13 per cent from last year's figure. However, a larger carryover will help keep total supplies for the 1978-79 marketing year at a high level.

Within the Tenth District, 1978 winter wheat acreage will be about 13 per cent smaller than in 1977. But the prospects for higher yields in 1978 are excellent since most of the wheat is in better condition now than it was last winter when severe cold and drought were affecting the District's agriculture.

Most Tenth District bankers contacted report loan demand is up sharply. Loans for natural resource development and energy-related businesses continue to be a source of strong demand, and credit needs for retail inventory financing have increased. Many bankers report heavy credit demand from agribusiness and from country banks to finance farm needs. In Lincoln, however, there has been a significant paydown in correspondent bank loans related to agriculture, as farmers have reduced their debts to banks by borrowing from the Federal Government. Consumer credit card loans have increased sharply at many of the banks surveyed, but auto loans are weak in most areas of the District.

Deposit growth has been good at District banks. Demand deposits have increased at several banks due to large public deposits. Passbook savings deposits continue to decline although outflows are reported to have moderated from the second and third quarter declines. Other time deposits and large negotiable CD's have increased. Bankers anticipate sharp disintermediation if short-term interest rates rise to 7 per cent. Several bankers feel that deposit growth will not keep pace with loan demand and that they will have to purchase funds in the near term.

ELEVENTH DISTRICT--DALLAS

Business activity in the Eleventh District enters the new year on a note of strong economic expansion. The businessmen and Directors surveyed this month are optimistic about future business prospects. Christmas sales exceeded the expectations of many department store executives, and the outlook for future sales is bright. Auto dealers expect sales of 1978 models to be greater than 1977 models. Bankers report deposit inflows have slowed but do not see disintermediation becoming a serious problem. The booms in drilling and construction continue, with heavy demand for inputs to the two activities. The financial position of the agricultural sector is being squeezed by low crop prices.

The Directors surveyed this month generally agree that the pace of economic activity for the Southwest and nation will quicken in 1978. However, they all express concern that many of the economic and political uncertainties that discouraged capital investment in 1977 are still present. Only one Director expects that many of these uncertainties will be resolved and that business spending will move from the "maintenance" expenditures that characterized capital investment in 1977 to a greater emphasis on expanding productive capacity this year. Most respondents see little improvement in the national rate of unemployment and are forecasting a jobless rate of 6.5 percent by year-end 1978. Interest rates are expected to show only moderate changes in 1978--rising in the near term and falling by year-end. A small majority of the respondents thought that the rate of inflation would increase moderately rather than abate.

Department store sales in the Eleventh District ended 1977 on an upbeat with Christmas sales substantially above the expectations of most merchants.

Inventory levels were drawn down to low levels at many stores, and the clearance sales now underway are relatively small in volume. Most department store executives forecast increased sales for 1978. Some respondents feel, however, that part of the exceptionally high level of Christmas sales reflected advanced buying by customers and are predicting that sales this quarter may be weaker than they otherwise would be.

Although new car sales have slowed somewhat, auto dealers continue to express confidence that sales in this model year will exceed last year's level. Sales of intermediate-sized cars are especially slow. Inventories of domestic cars are above desired levels for most dealers. Foreign car dealers seem to be doing slightly better than domestic dealers in spite of recent price increases on foreign cars, and some Volkswagen dealers report that inventories are below desired levels.

At current interest rate levels, bankers report funds are being transferred out of demand and savings deposits and into certificates of deposit. Most do not expect disintermediation to become a serious problem. However, banks are having difficulty attracting new deposits, with consumer saving deposits especially weak. Demand for construction, real estate, and consumer loans continues to increase in the District, and demand for those types of loans is expected to remain strong throughout 1978.

Drilling activity is at an 18-year high, and drilling contractors anticipate continued expansion in 1978. Because of the high level of activity in the industry, the supply of oil field equipment is tight. The lead time required to deliver most equipment has doubled since last spring. A short supply of drill pipe is hampering some activity, but the problem is not acute. To meet demand, many oil field machinery and equipment manufacturers are

currently expanding or plan expansions of their production facilities in 1978. One respondent plans a \$6 million expansion that will add 600 new jobs.

The increase in construction activity in the District is also leading to greater output in several durable goods industries. Cement producers are expanding their operations to meet the increased demand for their products. Demand by construction contractors for metal buildings to store equipment and materials is increasing output in the fabricated metals industry. In addition, fabricated metal manufacturers report strong demand for solar panels and aluminum doors and window frames.

According to our latest quarterly survey of agribankers, reduced cash flows from low grain and cotton prices continue to squeeze the financial conditions of farmers. As a result, repayments of loans remain slow at rural banks, and the availability of loanable funds has decreased since October. Participations with nonbank credit agencies continue to rise. One banker noted that "many farmers will have to refinance long-term debt to meet operating and machinery loan obligations." With commodity prices at low levels, a large portion of the 1977 crops will be placed under the Commodity Credit Corporation loan program. Higher cattle prices and more profitable feeding margins account for much of the increase in feedlot placements. But dry weather and poor winter grazing conditions continue to force many cow-calf operators to cull herds. The farm "strike" movement appears to be gaining support, with the strongest backing in the grain-producing areas in West Texas.

TWELFTH DISTRICT - SAN FRANCISCO

Retail Christmas sales were up by double digits over last year for many Western firms. Since these sales were typically larger than expected, inventories were typically leaner than planned by year end. An apparent end to the drought is filling both agricultural reservoirs and mountain ski lifts, both of which were nearly empty for most of last year. Western firms are still highly liquid and western banks are comfortably liquid, though there were two reports of mild disintermediation. Related to the U.S. trade deficit, concern was expressed over the lack of competitiveness of U.S. goods.

Christmas sales were higher than expected and end-of-the-year inventories lower than expected in almost all areas of the district. Most areas experienced double digit increases in their Christmas sales over year-ago levels. In the Los Angeles area, sales of practically all items, except autos, were up 10 to 15 percent over last year, and this strength has abated only slightly in the post-Christmas period. A Chamber of Commerce survey of another Southern California city found this year's Christmas to be selling 17 percent better than last year's. In Portland, the largest department store reported a 12 percent increase and a large local chain a 21 percent increase in Christmas sales. Particular strength was seen in electronic games, food processors and TV/stereo items, and even foreign autos were selling nicely in Portland. In Seattle, even Christmas-week food sales topped last year's level by 20 percent, according to one large chain. Christmas sales were reported to be unusually heavy among both large and small retailers in various parts of Idaho, and Salt Lake City's major retail outlets were ringing up 12 to 15 percent more sales than a year ago. The only declines

in retail sales were reported on an Oregon Indian Reservation and in a drought-damaged agricultural part of Idaho.

The unexpectedly high level of sales left unexpectedly lean inventories. One Southern California city reported shortages in certain lines of toys, women's clothing and small appliances. One large Portland store reported that inventories were depleted a full week to ten days before expected. Lower than planned inventories were reported in virtually every part of the district. One note of concern came from a large California banker who characterized the season as a "credit card Christmas" and feared that optimistic retailers may restock inventories as if such sales would continue, while consumers will begin to feel overextended in their debt load and cut back their spending.

There are reports from the forest products industry that the supply of raw timber is down because environmental groups have blocked timber sales from government lands. The end of the drought has put the Western ski industry back on the road to financial health since extremely good snows are bringing droves of people to the mountains. The weather has imparted mixed blessings on California agriculture. While deepening snowpacks and rising reservoir levels mean more water for farming in 1978, the hurricane-force winds which ripped through California's Central Valley on December 20 have reduced farmers' net income by an estimated 20 million dollars. Up to half of the damage was confined to avocado losses, but damage was also reported in vineyards, citrus and almond groves, some field crops, green houses and irrigation systems.

When asked to comment on press reports of liquidity problems among banks and non-financial corporations, Twelfth District directors responded

that such reports appeared exaggerated and alarmist. Two years of strong profit growth combined with modest plant and equipment expenditures was said to have left corporations in strong cash positions. Most major forest products firms are able to fund their planned investments largely through internally generated cash. There was one report of a firm repurchasing its own stock. Overall, there was not a single report of a liquidity problem among Twelfth District firms, and many firms were reported to be in highly liquid positions. The only liquidity problems appear to be among farmers who are squeezed between low prices and high costs.

Most banks also report no liquidity problems, though one Salt Lake City bank hints that strong loan demand may soon spark a rise in interest rates and two Southern California banks have observed some disintermediation. In particular, one of these latter banks reported a 20 percent decline in savings certificate balances between August 1 and mid-December.

Several of our directors commented on the persistent U.S. trade deficit. Some echoed the prevalent explanation that the lagging economies of our trading partners were responsible for weak foreign demand and that our rapid import growth was due to purchases of foreign oil. A natural gas producer recently turned to Japan for "malleable pipe fittings" because U.S. fittings were of such poor quality, and for small trucks because the U.S. did not produce an equivalent product. One banker noted that foreign autos now capture 41 percent of Oregon's new car sales due to their high quality. He also noted that Oregon capital goods producers are losing their competitive edge due to government restrictions concerning ecology, human rights, boycotts and due to relatively non-aggressive action by U.S. export financing agencies (such as the Export-Import Bank).