

CONFIDENTIAL (FR)

CURRENT ECONOMIC COMMENT BY DISTRICT

Prepared for the
Federal Open Market Committee
by the Staff

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SUMMARY*

The tone of District reports is one of high employment of resources, accompanied by high operating rates in basic industries, shortages and lengthened deliveries, and generally tight labor markets. Upward price pressures remain intense. There is also an undertone of uncertainty and, indeed, concern over a slowdown or recession next year. Perhaps best illustrating the uncertainty are mixed comments on consumer spending and residential construction. On the other hand, capital spending and nonresidential building appear to be stronger than earlier expected. Credit demands are somewhat mixed, with softening noted for both C&I and mortgage loans. Crop prospects are generally favorable.

District reports frequently mention continued expansion in manufacturing activity and high utilization of capacity. New York notes some producers appear to be nearing limits of capacity. Both Chicago and Cleveland are relatively optimistic about steel production this quarter, which if it matches last quarter, would amount to about 85 percent of capacity, far better than a year ago. Some Districts expect slowing in business early in 1979 (Philadelphia, Minneapolis and Dallas).

Accompanying high levels of utilization in manufacturing and construction are reports of shortages of materials and labor. Districts report shortages of industrial and construction-related materials, ranging from cement (Chicago, Mineapolis and San Francisco) to drill pipes (Dallas). While shortages may not be

*Prepared by the Federal Reserve Bank of Cleveland.

a widespread problem, some Districts note stretching out of deliveries (Boston, New York and Kansas City). Similarly, complaints of labor shortages in a variety of industries are also noted (Boston, Chicago, Kansas City and San Francisco).

Still, uncertainty and concern mark comments about economic prospects over the short term. New York, for example, points out that respondents expect slower economic growth in the next half, but not a recession, and Chicago reports that pessimism is widespread in that area.

A majority of Districts indicate that retail sales have softened or have shown slower growth in recent weeks than earlier in the summer. Slower sales of major appliances are noted in some Districts (Boston, Chicago and Kansas City). Still, there are some exceptions to slowing tendencies. New York, Atlanta, Dallas and San Francisco report larger increases in sales in the past month than in the previous month. There is also a mixture of views concerning prospective sales. Retailers are optimistic in New York, Richmond, Minneapolis and Dallas, but those in Boston and Cleveland see further deterioration in sales.

The pace of housing and mortgage loan demand throughout the District appears to have softened. High mortgage rates, high housing prices and in some cases, more selective lending terms account for the lessened pace. Chicago, for example, notes that houses over \$100,000 are selling more slowly than earlier in the summer. In California, mortgage demand generally exceeds supply, but in other parts of the West, high mortgage rates seem to have slowed demand.

The investment sector provides more encouraging developments. Plant and equipment spending and nonresidential construction appear to be either accelerating or stronger than generally expected. Chicago reports that producers' durable goods sales appear stronger now than earlier in the year and that office building construction in that city is in a full-fledged boom. Atlanta notes that inflationary psychology has given an additional boost to an already large volume of nonresidential construction underway. Dallas also indicates construction of new plants and expansion of existing ones already exceeds all of 1977 and that the boom in oil and gas drilling continues. San Francisco remarks construction is still booming in most parts of that District.

Several Districts characterize inventory policies as cautious (New York, Atlanta and Minneapolis) or at about desired levels (St. Louis), but there are also reports of excess stocks, especially at the retail level (Boston, Cleveland, Richmond and Dallas). Also, inventories held by steel distributors are believed to be higher than desired (Cleveland and St. Louis).

Continued strong upward price pressures for a spectrum of industrial materials are reported in a number of Districts. Reports show continued widespread and substantial increases in prices (Philadelphia, Richmond and Kansas City). Atlanta stresses a fear of double-digit inflation has contributed importantly to the latest strength in consumer spending, capital investment and housing.

Credit demands are generally strong, but softening tendencies have surfaced in several Districts. Slower growth in C&I loans is reported in

some Districts (Boston, Cleveland, Atlanta and Dallas). Boston considers the slowdown temporary, while New York comments that commercial banks are generally optimistic over growth in loan demand through the first half of 1979. They point out a "spill-over" loan demand from regional banks in the form of loan participations. Latest increases in interest rates apparently have not slowed loan demand except for mortgages. The prevailing view seems to be that consumer installment and business loan demand has not yet slowed in response to higher rates (New York, Cleveland, Richmond, Minneapolis and San Francisco) but some other Districts express some concern over higher rates. Boston and Philadelphia see some signs of disintermediation and Chicago points out that recent increases have convinced some of the "inevitability" of a slowdown or recession next year in response to tightened credit markets.

Crop output in key farm belt regions is generally described as ranging from good to record harvests. Kansas City reports corn yields are good. St. Louis expects an above average crop sufficient to depress prices from a month-ago. Chicago expects a record year for corn and soy beans. On the other hand, Richmond and Dallas complained that dry weather has affected output of some crops.

FIRST DISTRICT - BOSTON

At their most recent meeting several Directors of the Boston Bank remarked that their own Roundtable discussion of business trends was becoming monotonous because of little change in their view of economic conditions. Directors and other Red Book respondents report continued healthy but not rapid economic growth with retail sales, employment, and commercial loan demand all doing nicely. Although there is no evidence of widespread shortages, certain labor markets are becoming quite tight and there are reports of stretch outs in delivery times of certain materials.

A Vermont banker reports that loan demand is very strong in his state and that he is beginning to have to turn customers away. This bank expects credit conditions to become considerably tighter and is making plans for rationing available funds. A large Boston bank reports that while commercial loan demand increased very strongly earlier in the year there was some slowdown in August. The chief executive officer of this bank believes that the August slowdown was only a temporary reduction in the longer term growth trend. He indicates that the bank has considerable liquid resources overseas and expects to be able to meet the anticipated increase in loan demand with no difficulty. Overall deposit flows remain fairly strong, although there is some evidence of disintermediation in savings and NOW accounts.

A local manufacturing conglomerate reports some slowdown in the sales of its household appliances subsidiary and expects a leveling off later this year as a result of the anticipated drop in new housing activity.

A division of this corporation which produces auto-related products is expected to see strong sales throughout the remainder of this year and well into 1979. A chemical manufacturer also reports that sales to tire producers have retained strong momentum.

An executive of a diversified local retailer indicates that sales across most merchandise lines remain very strong and that she would be very optimistic except for hearing continual forecasts for a slowdown. The chief executive of a large dry goods chain reports that although sales remain strong and above his firm's plan, he is somewhat concerned about inventories. While his stores do not have serious inventory overhang, it is higher than desirable and some adjustment will be necessary. He feels this pattern is also the case for other retailers, as well as for some manufacturers.

Although no Red Book respondents reported significant production problems as a result of an inability to obtain materials or labor, there are signs of a general tightening. A monthly survey of New England purchasing managers found some difficulty in obtaining certain types of steel and aluminum as well as electronic components. The operator of an employment agency reports increased difficulty in finding people. Similarly a Connecticut director indicates that many labor markets in that state are becoming increasingly tight because of expanded manufacturing activity, much of it defense oriented.

Professors Eckstein, Houtakker, Samuelson and Solow were available for comment this month. With the exception of Houtakker, none sees any

justification for further interest rate increases at this time. The majority argued that the Fed must allow for the lags in the monetary control process by waiting for evidence of the impact of past rate increases before pushing rates up further. While there was general agreement among the respondents that a more stringent voluntary wage and price control program is unlikely to have a significant effect on the rate of inflation, opinion was divided on whether such a policy should even be attempted. Solow feels that it could be marginally successful if properly applied, but Houthakker worries about its effects on the resource allocation mechanism and Samuelson fears it might induce a round of preemptive wage and price increases.

According to Eckstein, the recent figures suggest that the economy is passing through a phase of the credit cycle that in the past has always preceded a credit crunch. Events are unfolding more slowly than usual this time, but he warns that the present calm on the money markets need not persist. Eckstein believes that rates are already high enough to greatly increase the risks of a crunch due to an exogenous shock to the system, so the the Fed must be cautious about increasing rates still further at the present time.

Houthakker argues that the growth of the money supply has yet to show any evidence of restraint. As a result, he feels that the Fed is still accommodating inflation. Houthakker is dubious about the effectiveness of wage and price guidelines, noting that inflation cannot be reduced by a policy that suppresses competition. He finds the August foreign trade figures

most heartening, especially the strong growth in exports. It is Houtakker's view that with the depreciation now showing up significantly in the trade data, it is possible that the dollar has finally bottomed out.

Concerned that the Fed has been "painted into a corner" by its emphasis on money growth targets, Samuelson urges the Fed to allow some slippage in the money supply rather than risk a needless recession. He thinks that an appropriate policy is to aim at no less than 3 percent real growth, but that the recent interest rate increases may prevent such an outcome next year. Samuelson is critical of those advocates of incomes policies who see them as an excuse for another dose of "wild cats" fiscal and monetary stimulus.

Less critical of voluntary controls than the others, Solow believes that a set of wage and price guidelines is worth trying. However, since he expects the program's effectiveness to be directly proportional to the President's commitment to it, Solow feels that guidelines would prove harmful if announced and subsequently ignored. With respect to interest rates, Solow can see no justification for the recent increases, and is disappointed with the Fed's continued fixation on M_1 , despite the wide range of uncertainty surrounding the causes of its movements.

SECOND DISTRICT - NEW YORK

Business activity continued to advance in September at a moderate pace, according to recent comments of directors and other business leaders. Retail sales turned in a respectable performance despite the newspaper strike, and retailers seem to be guardedly optimistic about their prospects for the rest of the year. Elsewhere in the regional economy, business activity appears to be advancing nicely. While most respondents appear satisfied with current and near-term sales, businessmen are still keeping a tight rein on inventories. Indeed, in some cases, inventories reportedly are so lean that they have resulted in some stretching of delivery schedules. Looking ahead, there is an emerging consensus among respondents that the pace of business activity will slow down next year. Capital spending is expected to hold up while consumers become more tight-fisted. The recent firming in business loan demand at the New York City banks is also expected to continue.

Retail sales in the Second District chalked up healthy gains in September. Merchants in New York City reported that their sales were running slightly ahead of last year's pace. They felt that sales would have been even higher had it not been for the city's ongoing newspaper strike. Especially hard hit by the strike have been the sales of big-ticket durable goods, since they depend more heavily on advertised sales-promotions than do other consumer goods. Also, stores in Manhattan have been the ones most affected by the strike. Elsewhere in the Second District, and especially in New Jersey, retail sales have been fairly strong across a broad line of

goods. Neither retailers nor bankers professed to be worried about the much-publicized buildup of consumers' indebtedness. Almost without exception, the delinquency rates on consumer loans are reportedly remaining at comfortably low levels; and most consumer creditors feel that their customers are currently managing their debts quite well.

Outside of retailing, business activity appears to be advancing at a moderately brisk pace. Most businessmen who were contacted echoed the assessment of one upstate manufacturer of machine tools that business was "good" and there were "...no clouds hanging over the economy--except for inflation." Many businessmen feel that what is needed in the fight against inflation is a comprehensive and well-coordinated program. At the same time, they are also very disturbed about the proliferation of government rules and regulations, which result in nonproductive costs and delays. In any event, while there are no apparent shortages in materials, some producers appear to be nearing the limits of capacity. Nevertheless, virtually none of the directors or businessmen contacted anticipated a material change in the pace of capital spending. For example, one upstate manufacturer indicated that his firm was now bumping up against capacity ceilings for both brass and aluminum mill products, but does not plan to expand plant and equipment outlays at this time. When asked about the economic outlook for the next year and a half, most respondents foresee a slowdown in the rate of economic growth for the first half of 1979--but not an outright recession. As a rule, this projected slowdown is seen as the result of belt-tightening by consumers, with little attendant change in the rate of capital spending.

Business loan demand in the Second District is expected to retain its recent strength according to a survey of loan officers and economists at major New York commercial banks. The respondents were generally optimistic concerning the near-term business loan outlook despite rises in interest rates and competition from U. S. offices of foreign banks. All respondents confirmed receiving "spillover" loan demand from regional banks which primarily took the form of loan participations. There was disagreement to what extent these referrals reflect the increasingly "loaned up" positions on the part of the regionals or the size of individual loans that sometimes are too large for a single regional bank to handle for either legal or policy reasons. In any case, respondents assigned varying degrees of importance to spillover loans in boosting New York loan demand.

The majority of respondents gave optimistic forecasts of loan growth through the first half of 1979. All those questioned said that increases in interest rates have not yet affected loan demand. Everyone acknowledged loan competition by U. S. agencies and branches of foreign banks. However, some uncertainty was voiced concerning how much of this business was with traditional customers and whether the loans to nontraditional customers were similar in quality to those loans usually made to large domestic firms.

THIRD DISTRICT - PHILADELPHIA

Indications from the Third District are that current business conditions are good overall. Continued growth in the industrial sector and expanding employment are being reported. For the longer term though, manufacturers expect the economy to slip somewhat. Retail sales are mixed for the second month in a row, causing some merchants to believe the pace of consumer expenditures may finally be slowing down. Sales forecasts for the next two quarters are varied. Area bankers say business and consumer loan demand remains strong in October and look for slow and steady growth through early 1979. Interest rates are rising and are expected to peak in the first quarter. Although no serious disintermediation has been observed, bankers are concerned that it may become a problem in the future.

Manufacturers responding to the October Business Outlook Survey say the industrial sector continues to expand at about the same pace as last month. Supporting this claim, Survey respondents indicate higher levels of new orders and shipments and fractional growth of inventories. The continued expansion has given local employment a boost for the eighth consecutive month, with substantially larger payrolls reported in October as well as a marginally longer workweek.

Looking ahead six months, manufacturers continue to foresee a worsening of the business climate. Nearly one-third of the respondents this month expect a decline in general economic activity by the end of the first quarter. Consequently, new orders and shipments are projected to remain at their current levels and a fractional trimming of inventories is planned. Factory work forces are expected to hold their current levels over the period but a slight decline

in the length of the average workweek is planned. A Director of this Bank, whose business is in the manufacturing sector, takes issue with the view that a turn-down is imminent. His business is currently strong, and he sees no recession until at least 1980.

On the price front, over half of those surveyed this month report paying higher prices for raw materials, while less than one-third are charging more for their finished products. For the longer term, 80 percent of the respondents foresee continued increases in the cost of inputs, and 57 percent plan to hike the prices of the goods they sell.

Retail sales are mixed in October, according to local merchants. Reports of current dollar sales range from "just about even" to 14 percent above year-ago levels. Retailers at the lower end of the range say their sales are slightly below planned volume while for those at the upper end, sales are about 3 percent over anticipated levels. Inventories are reported to be in good shape. Contacts at the stores experiencing sluggishness in October cite several causes for the poor performance including uncertainty among consumers about the strength of the economy and the possibility that "the consumer may finally be reaching the end of his credit rope." It should also be noted that sales volume last year at this time was extremely high, making large gains this year difficult.

Looking ahead to the next six months, local merchants have widely varying expectations. Although some are fairly optimistic and look for first quarter sales to be as much as 11 percent higher than year-earlier levels, others are more conservative in their projections and expect to simply match early 1978 volume. None of the retailers contacted has assumed a tax cut in his forecast.

Local bankers say loan demand remains generally strong this month. Consumer loans continue to grow and C&I loans are reported to be 1 to 7 percent over year-end figures. Business loan demand is slightly ahead of planned levels overall. Bankers contacted say they have seen the underlying demand for business loans grow slowly and steadily over the past several months, so that unconventional loans are less necessary. As for the future, bankers look for continued strength in loan demand over the next two quarters. One contact feels that part of this continuing demand growth will come from the retailing sector. This person anticipates a slowdown in retail sales in the near future and, as a result, an increased demand for funds as retailers find it necessary to finance excessive inventories.

The prime rate at all of the banks contacted in October is 9 3/4 percent. Interest rates are expected to rise again in the near future, and to continue their climb through the first quarter of next year. All bankers contacted expect to see a prime of at least 10 percent by year-end, and a first quarter average of 10 or 10 1/4 percent. They look for a peak early in 1979 that could go as high as 11 percent.

Higher interest rates appear to have begun to take their toll on deposit flows. Although no one contacted sees a serious disintermediation problem yet, bankers are worried about a slow but accelerating runoff in time and savings deposits. The variable-rate money market certificate is mentioned as a primary force in counteracting possible deposit erosion as a result of high interest rates.

FOURTH DISTRICT - CLEVELAND

Economic prospects for the Fourth District this quarter are mixed; retailers are cautious over sales prospects, while steel shipments and production will likely match those of last quarter. Inventories of some types of retail goods and steel are generally higher than desired, but cutbacks are not expected to affect output and employment. Some letup in business loan demand is noted, though mortgage loan demand remains strong.

Retailers and producers of consumer goods remain cautious in their expectations for consumer spending over the next few months. Sales have been described as disappointing, and some retailers expect further deterioration during the balance of this year. Another official with a national chain still expects year-over-year gains to slip to a 7- to 8-percent range, down from 10-percent gains during the summer and 9 percent in September. However, a major producer of soaps, detergents and personal products notes larger year-over-year gains for its products, although total retail sales have been disappointing and are expected to continue to be so because of steady erosion of purchasing power. According to an official with a major appliance producer, sales have picked up sharply in the last several weeks, partly in response to promotions. Still, mass merchandisers--especially Sears, Penney's and Ward's--have cut back orders for early 1979 in expectation of reduced consumer spending.

Pockets of excessive inventories of some retail goods have surfaced in recent months. Retailers are concerned over heavier-than-desired inventories of general merchandise, despite efforts to tighten control of stocks.

Consumer response to the 1979 model automobiles cannot be ascertained for another several weeks until the newly designed Ford and Chrysler cars have been on the market. Some GMC dealers are pleased with the initial consumer response to downsized cars, on the market only since early October. Some dealers report a short supply of 1978 standard-size cars.

Prospects for steel production this quarter remain uncertain because of imports and inventories. Nevertheless, steel economists expect that shipments and production this quarter will be only slightly below the third quarter. Mills have recently been operating between 85 and 90 percent of capacity. Orders from the auto industry are heavy. However, demand from the construction industry has eased seasonally, and demand from steel distributors has weakened because of large inventories, especially of imported steel. Liquidation of these inventories depends on the next round of trigger pricing. One steel economist expects that a 10-percent trigger price increase might prompt distributors to cut their stocks of lower priced steel. Such a price increase would push foreign steel prices above some domestic levels, probably resulting in a long-awaited drop in steel imports.

Commercial and industrial loan demand has tended to flatten recently, according to a few of the largest banks in the District. Increased competition from commercial paper is largely believed responsible for this slowdown. In a related matter, two of the nation's largest tire producers had their ratings on commercial paper lowered from A1 to A2 because of a

highly leveraged capital structure in one case and a possible recall of some tires for the other producer.

Mortgage lenders remark that the volume of mortgage applications is still relatively strong, although softening seasonally. The prevailing mortgage rate for an 80-percent loan is about 9 3/4 percent plus 1 point although rates in some areas are as high as 10 1/4 percent. Deposit flows at S&Ls have been strong, particularly because of the 6-month certificate. This unanticipated strength has improved the liquidity position of several S&Ls in recent months. A \$500 million association reported that deposit flows in September were the best so far this year, although passbook savings have been negative for the past several months. S&Ls apparently will continue to promote the certificates, even with a runup in the cost of funds, as long as mortgage loan demand remains strong.

There is little sign that consumer or business spending is being curtailed as a result of further increases in interest rates. Mortgage lenders are generally pleased that higher rates have not shut off availability of credit, although there are some scattered signs that mortgage rates above 10 percent have hampered demand. A large District bank notes that higher interest rates have had no impact on sales of big-ticket goods. Rates on installment loans for autos have shown little increase because of competition from auto finance cost. Borrowing terms have not tightened, and may in fact have eased as maturities are lengthened. Businesses have not curtailed spending for inventories or capital equipment, especially where cash flows are still sufficient for the bulk of financing needs. Some comment, however, that continued increases in rates could hinder acquisition plans or spending plans in another 6 months.

FIFTH DISTRICT - RICHMOND

Reports from Fifth District businessmen remained basically positive in early October. Results of our latest survey indicate continued expansion of shipments and new orders in the manufacturing sector and of sales in the retail sector. Manufacturers also report month to month increases in backlogs of orders, number of employees, and weekly hours worked. It appears that credit demand in the District continues strong, although there are signs that the composition of demand is changing somewhat. Business lending has recovered from a short slump, and expectations are that such lending will accelerate. Real estate loan demand is healthy but moderating, and consumer instalment loan demand is matching its recent strength.

In the manufacturing sector activity remained firm in September as shipments, new orders, and order backlogs all were higher over the month. Better than a quarter of the manufacturers surveyed experienced a pickup in orders while more than one in three expanded shipments. Inventory performance was mixed as stocks of finished goods were down and materials on hand rose slightly. Total inventories remain, on balance, somewhat above desired levels. Our directors generally substantiate this view of inventory positions although one cites instances of tight inventory control having impaired sales performance in some firms. Manufacturers are, by and large, comfortable with their current plant and equipment capacity and there appears to be little sentiment for altering current expansion plans.

Retailers surveyed this month report widespread gains in sales and slight increases in relative sales of big ticket items. Inventories at retail stores have grown in recent weeks but remain only slightly above desired levels. Our directors

have noticed little change in retail sales in recent weeks, but several feel that consumers are poised for a fall buying spree once cool weather arrives, Concerning the automobile component of retail sales, Fifth District directors expect fall sales of new models to be only slightly weaker to unchanged from recent levels.

Manufacturers and retailers continue to report increases in prices paid and received. Such increases continue widespread among manufacturers but their incidence among retailers declined slightly over the past month. Manufacturers remain basically pessimistic concerning the six month outlook for the national economy and for their respective local economies. There seems to be no consensus, however, on the outlook for production in individual firms. Retailers participating in our survey expect little or no change in the level of activity nationally, locally, or in their respective firms over the next two quarters.

Commercial and industrial loans by Fifth District banks have exhibited strength in recent weeks, with extensions of large banks concentrated in trade and service industries. Bankers report that sharply higher rates on business loans have not discouraged borrowing. All of our banker directors report that they expect the credit needs of their business customers to be moderate to strong in coming months. Higher mortgage rates and more restrictive lending terms are clearly having an effect on the real estate loan market. Demand for mortgage loans has moderated, although only slightly. Commercial banks appear to be referring greater numbers of prospective mortgage borrowers to thrift institutions.

Liquidity at area banks has been diminished but Fifth District bankers seem to feel comfortable with their liquidity, given the vigorous state of credit demand.

Better grade prices and improved quality have continued to produce all-time high general average prices on most flue-cured tobacco belts in recent weeks. The season average price through September 28 was \$134.39 per hundred pounds, 12.5 percent above the comparable period a year ago. Meanwhile, gross sales have been 13 percent higher, with the value of these sales up 28 percent. With weather conditions generally dry during the month of September soil moisture supplies are rated as mostly short to very short throughout much of the District. The dry weather has reduced yield prospects for peanuts, soybeans, and corn and has slowed the pace of the peanut harvest. Pastures have declined and are now in mostly fair to good condition.

SIXTH DISTRICT - ATLANTA

An acceleration of activity has created further pressures on prices and supplies. The possibility of wage and price controls has undoubtedly begun to influence pricing decisions in some industries. Although businessmen expect inflation to accelerate next year, their cautious control of inventories has kept stockpiling to a minimum. The "inflation psychology" is thought to have contributed significantly to the latest strength in consumer spending, capital investment, and housing markets. Financial institutions are uneasy with the rising cost of money and automatic transfers on the horizon.

Business leaders in several major District cities have noted a variety of problems with short input supplies and slow deliveries. The latest list of shortages includes parts for aerospace and communications equipment, light-weight trucks, castings, aluminum alloys, and paper for telephone directories. Deliveries are reported to be "very bad" for auto parts and many building materials. Lead times are longer for office equipment, tools, and some steel goods and finished textile goods. On the other hand, there seems to have been some improvement in deliveries of wood, aluminum, aluminum containers, and insulation.

A poll of business leaders revealed that businessmen take the possibility of wage and price controls much more seriously than they did four months earlier. Quite a few suspected their suppliers, particularly manufacturers of building materials and steel makers, of raising prices in anticipation of controls. The fear of controls has been openly acknowledged in one industry whose product prices have been escalating

rapidly--food processing. Food processors have been raising list prices and discounting; food retailers, who reportedly consider the threat of controls less ominous, have raised prices in line with the increase in list, blocking the pass through of lower wholesale food costs. One contact remarked that next year's large union wage settlements would certainly bring on controls if something else doesn't before then; another thought that the mere mention of controls in the papers touches off a wave of price increases. Still, there remains a number of businessmen who feel that rising costs, not the fear of price controls, are the primary reasons for recent price increases.

The consensus 1979 inflation forecast of these business leaders was "we'll be lucky if it's not double-digit." Many offered predictions of increases in prices in their own industries--steel to rise 9 to 10 percent, shipping industry costs to gain 11 percent, costs in the soft drink industry to advance 8-1/2-11 percent, and the teamsters to get a 33- to 37-percent compensation hike.

In the face of such inflationary prospects, there is little evidence of businesses stockpiling to beat price increases. Inventory policies remain conservative. The inflation's psychology's impact can be seen in investment decisions and consumer behavior, however. Equipment suppliers find buyers moving up purchases; builders see projects coming off the drawing boards after long delays. Whether for this reason or others, the past month brought a rash of announcements of large building projects, both commercial and industrial, that will add substantially to an already sizable volume of nonresidential construction under way.

Consumer spending growth picked up in August and in September after the early summer slowdown. A remarkable number of contacts in a wide variety of consumer-oriented businesses noted that the higher-priced, higher-quality goods and services have been selling best. Automobile sales have been reasonably good, although late arrivals of 1979 models and thin carry-overs of 1978's restrained sales of new domestics in many areas. Red Book contacts characterize the younger consumer as motivated almost entirely by expectations of higher prices, ready to buy everything now that he can afford or meet the payments on, and having little use for savings.

High prices and expensive money have yet had little effect on housing markets in the rapid growth areas, but the end of the boom is in sight. Forecasts of a slowdown in 1979 are nearly universal, and some call for a sharper downturn than was anticipated earlier in the year. Sales and starts have already tapered off in many slower-growing areas, where unsold inventories are rising and builders and lenders have virtually ceased speculative ventures. There is some evidence that mortgage lenders have become more selective.

As business loan growth has slowed, banks have experienced exceptionally strong credit demands from consumers for both mortgages and consumer instalment loans. Auto loans of 42 and 48 months are common; one director reported that banks in his area are now offering 60-month loans. The financial community appears to be troubled by three recent developments. The new CDs have been of considerable help in maintaining deposits, but with T-bill rates approaching state usury ceilings on mortgage rates, many thrifts fear being priced out of the mortgage markets.

In Tennessee, where the usury ceiling is most difficult to skirt and applies to corporate loans as well, bankers are debating how much longer they can afford to pay the maximum rate on six-month certificates. Some say they won't hesitate to stop offering them if rates rise further; others feel they must hold onto these accounts and hope for a decline in rates because of stiff competition for deposits. Apparently, some banks have already suffered losses of funds because they were unwilling to pay the going rates. With the advent of automatic transfers at hand, bankers are struggling to develop satisfactory pricing schemes. Many view the service as tantamount to interest-bearing checking accounts and expect earnings declines like those that New England banks experienced with NOW accounts. There is some feeling that offering the service is "practically mandatory." A further concern is the uncertainty surrounding the regulations that will implement the Community Reinvestment Act.

SEVENTH DISTRICT - CHICAGO

The uptrend in business plant and equipment spending appears to have taken the leading role in the expansion while consumer spending has moderated. Pessimism is widespread among executives, lenders, and consumers, but no significant general weakening is expected through year end. Employment continues to rise. Housing activity continues to exceed expectations, but the market appears to be softening. Meanwhile, nonresidential construction is picking up speed. Record corn and soybean crops are expected.

Recent increases in short-term interest rates have convinced some observers that a slowdown or recession is inevitable next year as tighter credit policy begins to "bite." Tighter policy is accepted by most executives as necessary to slow inflation, except for those in the housing industry. Some executives state privately that wage and price controls lie ahead, despite disavowals. They believe associated market disruptions will endanger economic growth.

Comments on the proposed natural gas bill, which is expected to pass, are highly critical. The extremely complicated measure will create a "bureaucratic nightmare." Regulation of intrastate sales of gas is expected to increase interstate shipments and slow needed shifts to other fuels.

Although results vary by store, total retail sales appear to have advanced at a slower pace in the past month or two. Weakness has hit major appliances, especially refrigerators, freezers, washers, and dryers. Production has been cut back.

Despite a disappointing rate of sales in September, the market for motor vehicles is still believed to be strong--in the 15 million per year range.

Some models of cars are in short supply. The recent rail strike cut 45,000 autos out of September schedules. (A long strike obviously would be disastrous.) Auto makers are boosting prices on large cars in greatest demand, while they hold the line on small cars, to help meet CAFE mileage requirements. Experience with 42 and 48 month car loans has been very good. Even longer terms are under experimentation.

Overall, the producer goods sector looks stronger than earlier in the year. Output schedules for diesel engines, heavy trucks, freight cars, and construction equipment have been increased. Machine tool backlogs stretch well into next year. Bottlenecks are largely restricted to castings and skilled labor. Some companies would add shifts if enough skilled workers and managers were available. A large auto firm reports that over 90 percent of its large capital outlays are for mandated fuel and emission standards, rather than for expansion, or even better productivity.

Commercial and industrial construction activity is expanding. Office building construction in Chicago is in a full-fledged boom. New plans have been announced for luxury apartments and large hotels. Building in industrial parks is accelerating as vacant space declines. Two large regional shopping centers have been announced for the Chicago area, the first in several years.

The cement shortage has remained serious. Ready mix plants have been operating on short weeks. Sizable public and private construction projects have been slowed, or even postponed, because of concrete allocations. The situation is particularly severe in the Chicago area, because the Illinois Waterway has been closed for repairs, the normal channel for many barge shipments of cement and aggregate. Alternative transportation is judged prohibitively expensive for large users.

Record crops of both corn and soybeans are virtually assured. Despite late plantings, harvesting is on normal schedules. Many farmers will need private credit to carry harvests. Only 25 percent of corn production in Illinois is eligible for CCC loans. The proportion is 45 percent in Iowa and 30 percent in Indiana.

The "pack" of fruits and vegetables has been below expectations. Pork production is lagging despite apparent high profitability. These developments suggest continued upward pressure on food prices next year.

A major steel producer sees no sign of demand weakening as it did last year. In fact, order lead times have extended into January on cold-rolled sheets for the auto market. (Steel needs for autos will decline next year because of downsizing.) Orders for structurals and plates are improved, but lead times have not extended. More steel is going to service centers, which mainly supply the construction and equipment industries.

Transactions in homes appear to be declining as a result of higher prices and continued high interest rates, which eliminate more and more buyers. Homes priced at \$100,000 or more and lower-priced homes in less desirable locations are selling more slowly. After easing in midsummer, mortgage availability tightened up again in September. S&Ls are able to attract funds through MMCs, but they are increasingly uneasy about their growing dependence on such high-cost funds.

Demand for labor continues strong. Executive placement firms are doing a huge business. This year's college graduates had the best choice of jobs in several years. Unemployment claims continue below year ago in most areas. Surveys of hiring plans show that more firms expect an increase in employment than a decrease. Help-wanted ads in Chicago newspapers are running close to 30 percent above year ago, a wider margin of gain than in earlier months.

EIGHTH DISTRICT -- ST. LOUIS

Economic activity in the Eighth District continues to grow according to reports from area businessmen. Consumer spending is expanding moderately. Inventories are generally at or near desired levels. Loan demand continues up and savings inflows into financial firms remain at a relatively high level. Manufacturing activity is expanding, and occasionally shortages are reported. Inflation continues a major concern. Crop production prospects are generally good.

Consumer spending has expanded moderately in recent weeks following a lull in the late summer. One major chain store reported that sales in recent weeks were running about nine percent above year ago levels, while another reported little change in overall sales during the past four months, and only a two or three percent growth is expected for 1978. Sales by a major retailer of shoes were 10 to 12 percent above those recorded a year ago. Automobile orders are reported to be coming in well and another year of high automobile sales is expected.

Most respondents indicated that inventories were at or near desired levels. A representative of a major department store chain reported that a number of large department stores had started a move to place more control on inventories which may eventually involve some inventory reduction. A distributor of fabricated steel products reported that inventories were relatively high, but at a desired level. Inventory shortages were reported in a few lines of goods including cement, lubricating equipment, and pumps, and paper is expected to be in short supply by the end of the year.

With few exceptions, manufacturers note continued expansion. A

manufacturer of lubricating equipment, pumps, and other industrial equipment reported that orders were 10 percent ahead of a year ago and that inventories were low. A leading chemical producer reported that textile orders continued to be abnormally high, and that plastics are off seasonally but not as much as expected. Export orders for agricultural chemicals are very strong. A boxboard manufacturer reported a recent pickup in business following an August lull. Other areas of strength reported were juvenile furniture, sporting goods, fabricated steel products, and products used for mining coal and uranium. On the other hand, construction, especially of residential housing, may be declining somewhat, and some weakness was reported in industrial chemicals, automatic controls, and resins.

Businessmen in the area continue to speak of inflation as a major concern. Sharply rising prices were reported for a number of industrial raw materials and paper products.

Demand for credit is strong throughout most of the District and especially strong in the smaller communities. An Arkansas banker reported that almost all loans there are being made at the legal maximum rate of 10 percent and that consumer lending is being discouraged. Extension of mortgage credit in Kentucky continues unabated even at a 9.5 percent rate and a 25 percent down payment. Loan demand has increased somewhat in recent weeks in the larger centers, including St. Louis; however, demand here is still somewhat less than in the outlying areas. Counter to the general trend of credit demand, applications for home loans are apparently down in the St. Louis metropolitan area from a year ago. Home mortgage rates at 9.5 to 10 percent are unchanged from a month ago.

With the exception of a few areas which suffered from drought, above

average crops will be harvested in the District. The corn, soybean, and rice crops are generally good and harvesting weather favorable. Lack of rainfall resulted in below average crop yields in southwest Arkansas, western Kentucky, and parts of southern Illinois. Nevertheless, the unexpected size of most crops was sufficient to depress average crop prices from month ago levels.

NINTH DISTRICT - MINNEAPOLIS

No significant changes in either the economic or financial condition of the Ninth District were observed this month. The vital signs of the region are favorable, and respondents to this month's Redbook inquiry are basically optimistic. Inflation continues as the major economic concern, since current interest rates are doing little to slow loan demand.

Throughout the district, industrial production is characterized as "reasonably favorable" to "very good." A gradual slowing of growth rates is expected, in part because comparisons are now being made with months which were very good last year.

The heady pace of residential construction has moderated slightly as compared with last year. But commercial construction activity remains hectic.

Ag production is proceeding nicely this year. Record small grain crops are reported in North Dakota. The excellent yields and higher ag commodity prices, especially for livestock and dairy, should improve farm incomes this year. Grain hauling was somewhat impeded by the rail strike, but this was not a serious problem.

Inventories are characterized as "normal" to "manageable," and virtually no one is seeing any buildup. Our observers consider an inventory induced turndown very unlikely because of the conservative stocking policies being followed by area businesses.

There are still some reports of cement shortages, but the problem is not as acute as it was last month.

Retail sales are generally reported as "normal," "good," or "strong" throughout the region. There are spot reports of softness in nondurables, but big ticket items are strong and auto dealers are happy. Most observers think retailers are quite optimistic about the fourth quarter. The improvement in ag earnings is sustaining implement sales and otherwise boosting economic activity in rural communities.

Ag banks in the district continue to report heavy loan demand and little deposit growth. Apparently farm receipts are coming in a bit late this year. Grain is being put in storage, cattle are not yet moving in Montana (although some handsome contracts have been drawn), and set-aside payments haven't been made.

But this situation should change soon, so deposits at rural banks are expected to show growth in late October and in November. Ag loans are now being repaid, but expectations of strong loan demand next year are widespread.

Money market certificates-of-deposit are still selling well throughout the district. These instruments don't account for a significant percentage of consumer time deposits here, but they have helped stem the erosion that was seen earlier this year.

Throughout the district we are hearing reports that loan demand has not slowed despite high nominal interest rates. With the current inflationary psychology, borrowers apparently are attempting to stay ahead of expected price increases.

Big businesses, which cite inflation as the economy's number one problem, are finding that their low inventory positions are giving them the liquidity they need to finance internally. It seems obvious, then, that the nominally high interest rates are not so high that they pose any kind of threat to district economic activity.

TENTH DISTRICT—KANSAS CITY

Business activity continues to be strong in the Tenth District. The volume of consumer purchases at retail stores is growing, some labor markets are tightening, and prices are rising rapidly. Inventories at retail stores are viewed as satisfactory, as are materials inventories of manufacturers. Fall planting and fall harvests are both progressing well on the District's farms. Loan demand at commercial banks remains strong, and deposit growth is moderate.

Most Tenth District retail stores surveyed are reporting sales increases (dollar volume) about 10 to 12 per cent ahead of year-ago levels. Sales of men's and women's apparel, appliances, and furniture have shown the greatest strength. However, there seems to have been a softening in consumer purchases in recent months, as inflation worries apparently are having an effect on buying. Most retailers are passing on cost increases to their customers, in order to maintain profit margins. Inventory levels are generally reported to be satisfactory. Those stores with growing inventories are chiefly in areas with rapidly growing sales. The outlook for the rest of the year and the first half of 1979 is mixed. Those companies with stores in areas with booming economies (i.e., Denver and Kansas City) are especially optimistic.

Compared to this time last year, prices for most major industrial inputs are up approximately 8 to 10 per cent, according to Tenth District purchasing managers. During the past three months, the August steel price increase has contributed to a 5 to 8 per cent increase in major inputs for the small appliance, machinery, and agricultural equipment industries. Reactions toward anticipated price increases for the remainder of the year

are mixed, with those industries which rely on primary metals products expecting increases ranging from 2 to 6 per cent.

Input material availability is beginning to present some problems, as lead times are lengthening in all industries contacted—particularly in the aerospace, agricultural equipment, and office and computing equipment industries. For the aerospace industry, this problem is particularly acute and is expected to worsen throughout the year. For the other industries, purchasing agents have been able to adjust for the lengthening, thereby avoiding any significant availability difficulties.

Currently, material inventories are at satisfactory levels. Over the past few months, inventory expansion has occurred in the aerospace, agricultural equipment, and machinery industries. This action is partly a hedge against possible ill effects from another hard winter, and partly the result of expectations for strong future demand. These industries expect to continue their inventory expansion for the remainder of the year.

Skilled labor for the aerospace industry is in short supply, and plant operations are at full capacity. The small appliance industry is experiencing some difficulty in finding assembly line workers, but is still operating at near full capacity. The remainder of the industries contacted are experiencing no real difficulties with labor supplies or plant capacity.

Planting of the new winter wheat crop is progressing reasonably well, although hampered by a lack of moisture in some areas. However, most observers expect that the planting process will be completed fairly soon and that the new crop will probably be reasonably well established before it goes dormant for the winter.

The dry weather has been conducive to the harvesting of fall crops

in the District. Though the harvest is running a little behind normal, good progress is being made. Generally, corn yields are good, especially in Nebraska where a very large crop is expected. The prospects for soybeans are somewhat spotty in the District, because of the weather problems that were encountered last spring. Many people remain quite concerned about the availability of storage and transportation facilities. Most commercial facilities are full, but new on-farm storage may alleviate most, if not all, of the potential storage problems.

Most bankers contacted in the Tenth District report that loan demand remains strong, with particular strength in the demands for agricultural and real estate loans. Demands for commercial, consumer, construction, and energy-related loans are also reported as moderate to strong. Nearly all bankers contacted raised their prime lending rates last month and expect further increases before the end of the year. Most have followed the money center banks to current prime rates of 9 3/4 per cent. About one-half of the bankers contacted have either tightened other lending terms recently, or expect to do so in the near future. Yet most bankers expected no problems in meeting future loan demand. However, some may cut back on real estate loans.

Deposit growth is moderate at most banks contacted. Demand deposits are flat or up moderately; savings deposits are flat or down slightly from a year ago due to higher interest rates and shifts to money market CD's; and time deposits are generally up over a year ago. With the possible exception of demand deposits, deposits are expected to grow moderately in the near future due to crop harvests, higher cattle and grain prices, and a boom in energy-related industries. Most bankers contacted will offer automatic transfers beginning November 1 but do not anticipate a strong response immediately.

ELEVENTH DISTRICT--DALLAS

The Directors and businessmen surveyed this month report no significant change in the strong pace of economic activity in the Eleventh District. Auto and department store sales continue to grow. Low inventory levels have limited new car sales somewhat, although inventories at department stores are more than ample. Manufacturing activity also remains strong, and construction of new plants and expansions is well ahead of a year ago. Loan demand at both banks and savings and loan associations appears to have slowed from the peak rates recorded earlier this year, while deposit inflows continue to grow moderately. Our October survey of agribankers indicates funds available for farm loans are in short supply.

Auto sales are up across the District and could be even better if dealer inventories of 1978 models were larger. Bargain hunting for 1978 cars is on the rise, but early sales of the 1979 models are strong. Several dealers also note that used car sales have picked up recently in response to higher new car prices.

Department store sales remain 12 to 14 percent ahead of a year ago. Many merchants, however, appear overly optimistic as to prospects for sales, and excess inventories have developed at a large number of stores. Several stores are using promotional efforts to reduce excess inventories. Others, however, appear willing to carry heavier than normal fall inventories into the Christmas season. Much of the strength in department store sales at the present time is centered in sportswear and sporting equipment. Other goods selling well include home furnishings and appliances.

High production levels remain the norm for the manufacturing firms surveyed, but many respondents expect a significant slowing in business next year. Higher materials and labor costs and declining productivity continue to be cited as major problems, but they have not had any visible impact on output. In fact, the District's industrial base continues to expand. An electric utility, for example, reports that there were more new plants and expansions constructed in its service area during the first eight months of this year than for all of last year. Much of the growth is in the electronics, oil field equipment, and auto-related industries. While several large chemical plants are under construction, some plant expansions have been delayed in light of the large amount of new capacity coming on stream.

The boom in oil and gas drilling activity continues in the District, but the current surplus of natural gas in the Texas intrastate market has reduced the number of active rigs in South Texas. The current high level of activity has produced numerous equipment shortages including drill pipe. A major oil field equipment manufacturer reports that a shortage of cobalt used in alloyed steel products is developing.

Industry sources describe production of petrochemicals as "good." One respondent, however, indicated output may have peaked during the second quarter and expects a moderate decline in sales and continued soft prices. Benzene is the only major chemical that is in "extremely" short supply.

Lending activity of District banks appears to have settled back to a moderate rate of expansion compared to the record rates of growth in the first half of the year. With liquidity levels high at most banks, loan officers are becoming more aggressive in seeking out new borrowers.

In the face of rising interest rates, however, bankers are particularly eager to make short-term loans. But many expect interest rates to peak in the next few months, and some indicate that they may begin moving into long-term contracts in the near future. Total deposits at most banks continue to grow slowly, although demand deposits declined slightly in conjunction with the September 15 tax payment date.

Mortgage lending by S&L's remains strong but has backed off from the frantic pace experienced several months ago. A further gradual slowing in mortgage demand is expected. Savings inflows continued to grow at a moderate rate in September, but inflows remained below year-earlier levels. Insurance company and foreign money are reported to be available in large amounts for real estate financing and purchases.

Preliminary findings from our October survey of agribankers indicate that funds available for farm loans are in short supply and that few bankers are actively seeking new agricultural loan accounts. Interest rates for all categories of farm loans have climbed rapidly in recent months with the general rise in interest rates and with expanded demands for feeder cattle and operating loans. Financial conditions in the livestock sector are much improved from a year ago. However, crop farmers are in a much worse position than last year as much needed rains arrived too late to raise yields to normal levels in many areas.

TWELFTH DISTRICT - SAN FRANCISCO

The economic health of the West appears to be somewhat stronger than reported last month. Retail sales are up due both to a back-to-school surge and a Boeing-led boom in the state of Washington. Construction continues to expand in most parts of the District, and perhaps a bit too strongly in southern California. Several industries report increased export sales due to the decline of the dollar. Mortgage interest rates have begun to move up another notch in California and many observers feel that this will be the peak for this phase in the cycle.

Growth in retail sales is generally stronger than reported last month, due partly to a back-to-school surge and a population boom in the state of Washington. The largest department store chain in southern California reports that sales in the first two weeks of September are up 18 percent from year-earlier levels. Elsewhere in southern California, retail sales were reported to be growing at a rate of 10-15 percent over the past two months. Oregon also reports strong consumer spending. But Washington appears to be turning in the strongest performance with retail sales running 30 percent above a year ago. Much of this is due to a Boeing-led economic and population boom--car registrations are up 20 percent from a year ago. Domestic auto sales are reported strong all over the District and there is an actual shortage of new trucks in southern California. Imported auto sales are somewhat weaker.

Construction is still booming in many parts of the district and is felt by one director to be "too strong for a healthy industry" in southern California. Most of the strength there is in non-residential, but there are still reports of condominium developments selling out before the foundations are laid. One builder-director expressed serious concern about construction

costs which he claimed to be advancing at 1 percent per month, due to declining worker productivity and rising input (especially land) costs. Furthermore, many labor contracts expire in spring and he fears substantial wage increases. Shortages of skilled workers, cement, air conditioning, electrical equipment, tile, wood and assorted other materials are reported in this southern-California construction boom. While construction elsewhere in the District remains generally strong, Idaho does report a slow-down due to a shortage of funds caused by interest rates bumping against the State's usury ceiling.

The effect of the dollar's decline on western industry is mixed. Naturally, a number of industries neither buy nor sell abroad and have thus been fairly well insulated from international currency movements. Others have been affected either on the input or output side, or both. The aluminum industry notes increased costs for imported raw materials but no stimulation of export sales. The forest products industry has noticed a significant rise in their sales abroad--much stronger than would normally be expected at this phase in their export cycle. A major chain saw company related that its foreign sales have increased nicely due to its increased competitiveness with its chief competition, which is located in Germany. An electronics firm also notes a strong increase in export sales. In the opposite direction, a director involved in the media related that foreign auto dealers in Washington are increasing their promotional activities to counter resistance to higher prices.

Most California S&L's have raised their prime loan rate for residential mortgages from 9 3/4 to 10 percent. The former rate had been in effect since mid-August. This move was explained as an adaptation to the higher costs resulting from a significant transfer of funds from passbook savings into the higher-interest money market certificates. At this writing, banks had not joined

in the increase, but there is every indication that they will. Our bank directors in California generally report stronger mortgage demand than they can satisfy, so something must give in the near future--either a weakening in demand or an increase in rates.

Elsewhere in the District a slight softening in mortgage demand is noted and often attributed to high mortgage rates. Most feel that mortgage rates have peaked, but there is a split between those who feel that rates will remain at their present, high plateau for some time, and those who see a decline before the end of the year. The former group argues that the high cost of money will keep rates up despite any weakening in mortgage demand. Some of this group also doubts that any significant weakening in demand will continue, because consumers continue to perceive home ownership as one of the best hedges against inflation.

Our non-bank directors were generally unperturbed by high money market rates. Both a large clothing manufacturer and a large forest products producer claimed to be net lenders in the money market and were thus positively affected by the hike in rates. Kaiser Aluminum noted that its investment plans would be changed only in reaction to a significant change in long-term rates. There were, however, several reports of efforts to reduce inventory levels as a result of high short-term rates. And one university noted that with the high rates coming in summer, which is their peak seasonal borrowing period, they had had to postpone several projects.