

CONFIDENTIAL (FR)

CURRENT ECONOMIC COMMENT BY DISTRICT

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by the Staff

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SUMMARY*

District reports continue to point to a slowdown in economic activity in the second half of the year. However, current retail sales and manufacturing activity continue to advance at a rapid pace, although some industries have entered their normal midsummer doldrums. Businessmen continue to manage inventories closely, and growing uncertainty is deterring some capital spending. Higher prime rates are expected as loan demands strengthen and bank deposit inflows slow further. Although higher interest rates are not expected to impact significantly on business borrowing, they have led to fewer mortgage commitments. The prospects for farm income are improved, and the demand for new equipment in some areas is rising.

Modest to brisk gains in retail sales are being reported across the country, although the expected strength of sales at year-end remains uncertain. New cars continue to sell well, but sales of other durable goods are mixed. Minneapolis and Dallas suggest that retail sales are increasing at unsustainable rates, while Atlanta indicates a similar situation for new car sales. Chicago reports that consumers continue to use instalment credit freely, and there is concern in the New York district that mounting consumer debt will soon slow sales. Inventory levels remain within manageable limits, although Boston, Cleveland, Richmond, and Kansas City indicate stocks are on the high side. Atlanta is the only district where retailers plan to build inventories through the summer.

*Prepared by the Federal Reserve Bank of Dallas.

Industrial production continues to grow at a brisk pace in most districts, as evidenced by expanded employment, increased shipments, and rising prices. Although some industries, such as autos and coal, have geared down to slower rates of summer output, production in such durable goods industries as fabricated metals, transportation equipment, construction materials, and defense goods are on the rise. Nonetheless, many manufacturers are pessimistic about business conditions at year-end and are keeping a tight rein on factory inventories.

Despite the recent runup in imports, steel companies in the Cleveland and Chicago districts remain heavily booked, and production is expected to remain strong. But inventory levels, especially in the distribution channels, are building and may hamper further price increases.

Capital spending plans vary widely. Low rates of return and uncertainties over inflation, government regulations, and economic policies are listed as obstacles to increasing capital outlays. San Francisco notes investment plans by several industries are short of that needed to meet future product demand. While no significant changes in capital spending are anticipated by Philadelphia, large expenditures are in the offing for commercial aircraft, rail cars, and heavy trucks and trailers, according to New York and Chicago.

Credit demands at commercial banks are expected to strengthen for the remainder of the year. Continued slowing in deposit growth is holding down the liquidity positions of most banks, and bankers are becoming more selective in processing loan applications. While business loans, consumer instalment credit, and agricultural lending account for much of the growth in bank loans in many districts, New York points to the financing of

mergers and acquisitions and inventories as sources of loan demand in that district. Interest rates are expected to continue to rise with the prime rate climbing 25 to 100 basis points by year-end, according to Philadelphia and Kansas City. Although the new six-month money market CD's appear to be adding little to overall deposit growth, they are helping many banks, and especially S&L's, to hold on to some savings deposits.

Residential construction in many areas is being pinched as tight mortgage markets are leading to sharp reductions in new commitments. Chicago indicates that residential permits and sales of existing homes are down 30 to 40 percent in some areas from a year ago. The uncertainty of property tax cuts promised by Proposition 13 is an additional factor that is holding back home sales, according to San Francisco. Slowdowns in residential construction are anticipated by St. Louis and Minneapolis, while Cleveland reports housing starts will remain strong for the remainder of the year, regardless of sales. Demand for mortgages also remains vigorous in the Atlanta and Dallas districts.

Financial conditions in the agricultural sector show some improvement with higher livestock prices. But Atlanta reports some weakening of farm prices in recent weeks, and Kansas City indicates that the abundant wheat harvest should preclude a runup in wheat prices. Prospects of improved farm incomes are adding to demands for farm equipment, according to Chicago, Minneapolis, and Dallas. Soil moisture conditions are generally adequate, but shortages are reported in the Southeast and portions of the plains.

FIRST DISTRICT - BOSTON

First District respondents report that business is brisk and that, as yet, there are few signs of an economic slowdown. Manufacturing production and new orders continue to rise and retail sales remain strong. There are scattered reports of labor shortages. There is, however, some concern that inventories may be too high in view of the growing number of forecasts of an economic slowdown.

Among participants in a survey of manufacturers there was an increase in the number reporting higher shipments. New orders are also on the rise. The fabricated metal industry is doing particularly well. In southern New England, several large firms have backlogs of defense orders which are just now reaching the production stage and promise employment increases even if the economy sags. On the other hand, one manufacturer of consumer durables reports that his products have begun to move more slowly. Inventories have increased for most manufacturers; but, although sales are strong, uncertainty about future economic conditions has made many very cautious about further increases. Among those who do wish to add to inventories there are a few reports of increasing delivery lead times. A shortage of skilled workers, particularly machinists, has been observed by firms in the transportation equipment and machine tool industries.

Consumer spending in the First District continues to be strong. Retail sales throughout the region were good in May and June and through the first week of July. The tourist industry in northern New England is faring very well. Retailers are somewhat apprehensive about the future course of the economy and some feel that inventories may be a bit high; but this concern is not based on

actual experience. Both a major department store chain and a large utility report that uncollectible bills and bad debts, which increase as the economy weakens, are low and falling.

The region's economists are, for the most part, considerably more pessimistic about the economic outlook than are most businessmen. At a recent gathering of business economists nine out of twelve assigned a probability in excess of 50 percent to the prospect of a recession in late 1978 or early 1979. Consumer debt, the rate of inflation and the Federal Reserve's response were the basis for their gloomy forecasts.

Professors Eckstein and Samuelson were available for comment this month. Both respondents agree that there is a very real possibility of a "credit crunch" developing in the second half of this year, although neither believes that the present level of interest rates will necessarily lead to this outcome. They also agreed that while an overly ambitious attempt to slow the rate of money growth could easily produce a recession, the economy's prospects in the absence of this policy are for slower but still acceptable real growth in the months immediately ahead.

According to Eckstein, some signs of a credit crunch have already emerged. Specifically, the extent of the disintermediation that is currently being experienced by the Nation's commercial and savings banks is similar to that which developed in previous crunch episodes. On the other hand, the sudden shift in sales expectations characteristic of such periods has yet to occur, nor is there evidence of impending collapse in any segment of the financial markets. Eckstein is concerned, however, that an increase in the Federal funds rate to the 8-9 percent range may be sufficient to induce the massive deterioration in expectations that will result in a crunch and a

recession. He believes that "the Fed would then once again be disappointed by a recession-triggered policy of fiscal stimulus despite only a brief respite from inflation."

Samuelson likens the current period to the "slower motion" period preceding the sharp downturn late in 1974. Although he cannot predict a crunch on the basis of existing data, Samuelson fears that current high interest rates are increasing the chances of a growth recession. It is his view that the Fed may be overly restrictive in trying to maintain money growth within the existing ranges. Describing the present targets as "niggardly," Samuelson feels that since they have already been breached, and since inflation will not be cured by a "preventive" growth recession, there is no compelling reason to attempt to hold money growth to them.

SECOND DISTRICT--NEW YORK

Comments of directors and other business leaders indicate that economic activity in the Second District continues to expand moderately. At the same time, an increasing number of respondents voiced concern about prospects of a national slowdown or even a recession. Any downturn was expected to be relatively mild, in large measure because of the absence of imbalances such as excessive inventories, overbuilding, or serious shortages of labor or supplies. Indeed, although business conditions appear less buoyant recently than in the spring, many of those canvassed gave upbeat reports for their own firms, with a few noting a step-up in capital spending. Respondents unanimously viewed the recent increase in inventory investment as related to economic growth rather than hedge buying in anticipation of price rises. Leading New York City bankers expect some acceleration in loan demand over the remainder of the year.

District retail sales appear, on balance, to have posted a moderate advance in June and early July. Leading merchants in New York City characterized sales as "not bad," "reasonably good," or "on target." Reports from upstate respondents indicated that sales were reasonably good. Merchants differed in assessing the outlook for consumer spending. Some viewed consumer sentiment as uncertain while others expected retail sales to exhibit continued strength. At the same time, several business economists expressed concern that mounting debt burdens would slow consumer spending. The president of one of the District's leading retail firms discounted this view; however, noting that the amount of credit outstanding on a per account basis at his firm had risen only six percent over the past two years.

The capital spending outlook appears mixed. On the one hand, several industries--most notably the automotive and railroad sectors--were reported to be spending record amounts on capital investment. Producers of railroad cars are booked so solid that some firms are reportedly seeking foreign suppliers. One director noted that one of the region's major airlines is operating close to capacity and is planning substantial capital commitments. Further evidence that capital spending has firmed was offered by a major producer of machine tools who reported continued strong orders and high backlogs. On the less optimistic side, a number of respondents reported no plans for stepping up capital spending. Several executives felt that government policies played a crucial role in inhibiting investment. Among the chief influences cited were the costs of pollution control programs, whimsical changes in federal regulations, uncertainty over the administration's economic policy, and government's inability to control inflation.

The level of inventories appears to be in relatively good balance with sales. At the retail level, most respondents seemed pleased with current inventory levels, although a few viewed their stocks as slightly high. Recent inventory expansion was generally related to the strong economic growth posted in the second quarter. Uniformly, no respondents reported hedge buying in anticipation of heightened inflation. Nevertheless, inflation remains a primary concern of business executives. Most of the respondents felt that inflation was worsening and that rising prices would be a principal factor behind any economic slowdown. At the same time, many felt that the monetary authorities had done enough to fight inflation and that it was up to the government to curb prices by reducing fiscal stimulus. For the most part, respondents were skeptical as to the effectiveness of voluntary restraints.

Business loans at the large banks in New York City were essentially flat during June following a strong performance in May. Looking to the future, officers at four of five banks that were contacted foresaw some acceleration in loan demand in the second half of 1978 compared to the past six months. However, no one expected credit demands at anywhere near the rapid rates of expansion witnessed in the 1973-74 period. In explaining the pick-up in loan demand this year, the most frequently mentioned causes were financing of mergers and acquisitions and inventories. Most respondents said that it was too soon to tell whether capital spending would provide much impetus to loan demand. Two respondents said New York City banks were finally picking up loans partly because of the growing inability of regional banks to further supply customer loan needs. One respondent cited the rise in bond rates as at least temporarily stimulating demand for bank loans. Although the prime rate has risen 1 1/4 percentage points since the end of 1977, only one of the five respondents felt that it was having any deterrent effect on potential borrowers. In fact, one respondent cited fewer loans at below prime rates as evidence of a firming in loan demand, although another respondent indicated that below-prime lending was still common.

THIRD DISTRICT - PHILADELPHIA

Reports from the Third District indicate that regional economic activity is mixed. Business loan demand is strong at commercial banks and expected to improve further in the latter half of the year. Retail sales posted gains again in July, and although merchants have reservations about business conditions in the fourth quarter, they look for a strong fall season. Inventories are in "good shape" now according to contacts, and barring seasonal variation, no change in stock levels is planned over the next six months. District manufacturing growth has been stifled in July, but the slowdown appears to be a typical midsummer lull. If past seasonal patterns hold, we can look for a pickup in August. For the longer term, however, manufacturers are less optimistic than they've been in three-and-a-half years. Business at Third District vacation spots has been sluggish so far for the most part.

The recent expansion in manufacturing activity in the Third District has virtually died in July according to this month's Business Outlook Survey. Although work forces are larger at one-fourth of the firms sampled, general business activity, new orders, and shipments are all unchanged from their June levels. Inventories are slightly lower than they were a month ago. This midsummer slowdown may be seasonal though, and not a cause for concern. Such a drop-off in activity has been observed each July for the last eight years, and has typically been followed by an August rebound.

Looking ahead to January, Survey respondents foresee bleak prospects for the manufacturing sector. Less than one-third of those polled expect business conditions six months down the road to be any better than they are

now--the lowest this proportion has been since November 1974. New orders, shipments, and inventories are expected to remain essentially unchanged over the next two quarters. Consequently, Survey participants expect no increase in the size of factory payrolls over the period, and even a slight trimming of the average workweek. Moreover, the level of capital expenditures is projected to remain unchanged for the remainder of the year.

A Director of this Bank, whose business is in manufacturing, agrees that the picture is less than rosy. He foresees a lack of real strength in the retail sector and projects a slowdown in new car sales next year, both of which could have trickle-down effects on the industrial sector.

On the price front, inflation appears to have picked up steam again in the manufacturing sector after abating somewhat last month. Half of those responding to the Survey this month report higher prices for inputs, while about one-third say they are charging more for their finished products. For the longer term, about 85 percent of those surveyed expect to pay higher prices for raw materials by January, and almost 70 percent project price hikes on the goods they sell.

Area merchants say business is strong this month, with reports of current dollar sales ranging from 8 to 15 percent over July '77 levels and either "on target" or ahead of planned volume. Downtown stores and their suburban branches are doing equally well. Retailers say their inventories are at approximately the desired levels at this time.

For the longer term, merchants are becoming more uncertain about the remainder of 1978 than they have been recently. While they look for a strong fall buying season, some weakening is expected later in the year, leaving projected January sales volume only about 4 to 8 percent ahead of

year-earlier levels. Retailers may run into inventory accumulation problems in the next six months if the administration's proposed \$15 billion tax cut is not realized. As one contact points out, some merchants assumed a tax cut was in the offing when they made fall and winter buying commitments a few months ago. If no cut materializes, retailers may be caught with larger inventories than planned.

Contacts at the Pocono Mountain and South Jersey shore resorts say that tourist and vacation business has been generally less than anticipated so far this season, and, in some cases, is running behind 1977 levels. They attribute the sluggishness to several factors including unfavorable weather through much of the spring and early summer, and an extended school year as a result of last winter's snows. As for the balance of the season, resort entrepreneurs look for a pickup and expect total trade this year to be 6 to 12 percent ahead of last summer. One area that warrants comment is Atlantic City. Officials in that town say that as a result of the onset of casino gambling this year, hotel/motel reservations are running 10 percent ahead of 1977 levels with further gains projected for the rest of the season.

Commercial bankers in the region say demand for both consumer and business loans is strong in July. Commercial loan volume is up 8 to 10 percent from year-ago levels and either as planned or ahead of projections for this period. The growth in local demand growth is outstripping demand growth from elsewhere in the nation by a considerable margin. As for the future, bankers foresee further increases in loan volume over the next two quarters, with January levels 10 to 15 percent above year-earlier figures.

The prime rate at all of the banks contacted is currently 9 percent, and is projected to rise another 50 basis points by year-end. Bankers

foresee no significant disintermediation as a result of rising short-term rates. Deposit growth will slow, they say, but they do not expect a credit crunch.

FOURTH DISTRICT--CLEVELAND

Summer vacations and the model changeover in the automotive industry are hampering this quarter's production of autos, steel, and coal in the Fourth District. Retailers are facing a larger than usual liquidation of stocks of new cars and of general merchandise. Capital spending still lacks a broad-based expansion, and demand for mortgage credit continues strong despite higher interest rates.

Retailers in the District are still cautious in their appraisals of consumer behavior. Car sales have been sustained at near-record rates since spring. Still, some auto producers expect annual rates of sales this half to fall about 6 percent from the 10 million annual rate of domestic sales last quarter. Inventories are large and still imbalanced, but a larger than usual summer runoff of stocks is expected (especially with a longer Ford shutdown for model changeovers because of downsizing of Ford and Mercury cars). Uncertain over sales prospects, officials with department stores expect smaller gains in real sales for the second half of this year as compared to the first half. Strength in sales has not been broadly based, and inventories of summer goods are heavy. Thus, retailers of general merchandise will be forced to vigorously promote goods throughout the summer with the result that some department and variety stores will likely experience either no improvement or another decline in profits this quarter. Also, some retailers apparently will be cautious in ordering fall and winter merchandise. An official with a major appliance producer reports a strong increase in unit sales of appliances, especially freezers. He reports some excess stocks of ranges

and laundry equipment at the distributor level and believes stocks of appliances, except freezers, are large, although masked by a high volume of sales.

Steel production this quarter is not expected to fall as much as usual during the summer months, and industry economists expect the operating rate for the industry to hold close to 90 percent of effective capacity. Order books for July are full, in part because of another steel price hike at the end of this month, and order volume for August and September is better than expected in view of uncertainties over auto production and ample availability of world steel supplies. Steel economists are somewhat concerned over an unexpectedly large buildup of inventories held by distributors. While this buildup has not hampered orders, inventories may be more than ample later this year. Also, a common complaint is that the trigger price system does not seem to be working as evidenced by the much stronger than expected volume of steel imports in May. Steel price differentials have narrowed in favor of U.S. producers and have contributed to a sharply reduced volume of imports from Japan and Western European producers. But imports this year from Third World nations, including Korea, South Africa, and Spain, have risen sharply from a year earlier. Unless imports in June and succeeding months abate from the 18 million ton annual rate in May, some domestic producers may consider filing dumping charges.

The rebound in coal production following the long strike is being temporarily hampered by usual summer vacation shutdowns of mines. Production has failed to reach peak levels of late last year, which according to an industry economist, reflects weaker than expected demand for coal.

Coal stocks apparently were not run down as badly as reported during the strike, and utilities are not rebuilding stocks as much as expected. According to some utilities, electric power consumption since the coal settlements has not risen in line with industrial activity because of conservation programs.

The continued lack of broad-based strength in capital goods industries is hampering a robust expansion in spending. For example, capital goods producers of rolling mills and steelmaking facilities still see no meaningful strengthening in sales this year. They report that their order backlogs so far this year have trended downward. A producer of turbines, generators, and nuclear systems reports sales to utilities are still soft, although industrial equipment business continues to be strong. On the other hand, a producer of computers, point-of-sale terminals, and electronics business machines reports sales and backlogs continue to rise, although not at an accelerating rate. A producer of printing and communication equipment reports a spurt in orders in June following a May drop and that backlogs are still growing but less rapidly than last winter.

Builders and mortgage lenders concur that demand for housing and mortgage credit remains strong, although there are some scattered signs of buyer resistance to high prices and tightened mortgage terms. Consumer resistance to higher mortgage rates is not as strong as during the tightness in mortgage markets in 1974, according to a financial officer with a major national builder of new houses. He expects housing starts to remain strong at least through the fourth quarter of 1978 regardless of sales. His firm's backlog has been stretched out because of bottlenecks in skilled

labor and materials. Mortgage lenders, particularly S&L's, report little sign of easing in demand despite rising mortgage rates. In Cleveland, for example, the rate of 80-percent loans is generally 9 3/4 percent, but a few S&L's are charging 10 percent. Some are no longer making 95-percent loans or investment loans on land, apartments, and multifamily units.

S&L's are quite pleased with response to the six-month savings certificate and indicate no waning in consumer interest since the initial offering in early June. These S&L's, however, have been aggressively promoting certificates. Their view is that these certificates helped boost deposits in June to the best volume so far this year and have enabled these associations to meet strong loan demand. Some report that at least 60 percent of the certificates represent new money.

FIFTH DISTRICT - RICHMOND

Responses to our latest survey of District manufacturers suggest some slowing in the rate of expansion over the past month. Shipments continued to grow but new orders were essentially flat and backlogs of orders declined somewhat. Inventories were unchanged, remaining moderately above desired levels, and inventory policies continue on the cautious side. Retailers, on the other hand, report improvement in sales and relative sales of big ticket items over the past month. Expectations have become mixed. Manufacturers surveyed have turned decidedly pessimistic about the national outlook while retailers and Richmond Directors retain basically positive expectations for the second half of the year. Credit market activity in the District is brisk, with some institutions reporting record consumer and commercial lending in June. Real estate lending, while showing some signs of tapering, is still vigorous.

District manufacturers continued to expand employment and weekly hours over the past month as their shipments continued to increase. But in the face of stable new orders some reduction in backlogs resulted and further improvements in employment are doubtful. Inventories of both materials and finished goods were virtually unchanged and inventory positions relative to desired levels improved slightly. Although one-third of the manufacturers surveyed view current stocks as excessive, a small number consider them inadequate. Most respondents view current plant and equipment capacity as about right and there is little sentiment for altering current expansion plans. Manufacturers also continue to report widespread price increases, but such reports were slightly less common this month than last.

Retailers' responses were somewhat more positive. Total sales were up in June as were relative sales of big ticket items. There is some question, however, as to whether these increases involve more than just price changes. Nonetheless, retailers are encouraged by recent performance and look for continued improvement. Inventories at retail were larger than a month ago, but remain in line with desired levels. One of our Directors attributes current satisfaction with inventories to the relatively strong sales activity of recent weeks. He feels that even a minor reversal in sales would lead to a rapid turnaround in retailers' views of current inventory levels.

Current expectations vary widely from sector to sector. Manufacturing respondents have become pessimistic over the past several months; half now expect the general level of business activity nationally to worsen over the next six months. Their expectations for their respective firms and market areas are not quite that weak, but are essentially negative. Retailers, on the other hand, are basically optimistic, with most expecting further improvement nationally, locally, and in their respective firms over the remainder of the year. Most of our Directors who commented on this topic expect second-half growth, nationally, to be somewhat below that for the first half of the year. Specifically, they expect real GNP growth in the 3-4 percent range. Current perceptions of local labor market conditions are likewise varied. Comments by Directors suggest some tightness in markets for specific types of employees and in areas which have recently experienced rapid growth or development. Otherwise there is no indication of impending constraints arising from labor market conditions.

Bank business lending seems to be generally stronger than expected. Recent increases in commercial and industrial loans have been concentrated in

the durable goods, retail trade, and transportation sectors. The coal industry has also been a big borrower of late, leading West Virginia banks to increase their requests for loan participations with correspondent banks. A clear cut pattern has emerged in business use of loan proceeds, with capital expenditure financing explaining the largest part of commercial and industrial loan demand. Consumer installment loans of commercial banks have increased rapidly in recent weeks, largely as a result of healthy automobile sales. Bankers seem to expect continued strong demand for installment loans over the near-term, although some note that consumers' interest in big ticket items may be cooling off. Demand for residential mortgages continues strong, and is responding only moderately to increases in interest rates. Real estate loan demand is not limited to the single-family area. There is still interest in borrowing to finance construction of apartments and condominiums, although the latter are intended as primary residences, not second homes. Area banks seem generally comfortable with their liquidity positions, but thrift institutions are concerned about low rates of deposit growth.

The District's total cash farm income, led by significantly higher livestock receipts, continues to show a slight improvement over a year ago. Soil moisture conditions throughout the District were marked by considerable diversity as of July 1. Moisture levels ranged from short to very short in South Carolina, with drought conditions broadening and cutting yield prospects, to mostly adequate to surplus in West Virginia. Elsewhere, soil moisture was also short in slightly more than half of North Carolina but generally adequate in Maryland and Virginia. While conditions of most field crops and pastures were generally rated as fair to good, apple and peach prospects were reported as good to excellent.

SIXTH DISTRICT - ATLANTA

Although businessmen increasingly regard prospects for late 1978 and 1979 as questionable, recent business reports have been largely good. Consumer spending, still heavy, may have weakened a bit in late June. Inventory trends are not clear, but we may be in for some additional accumulations at the producer or wholesale levels. Construction activity and prospects remain strong. Credit demands are hefty, with sources of loanable funds generally adequate. Farm product prices have softened; dry weather and labor shortages have made trouble for crop producers.

Retail sales remain generally strong, but directors in several areas reported a moderation in late June, particularly in sales of big-ticket items. Elsewhere, durables still appear to be dominating the sales gains. More than one retailer has complained of sluggish repayments.

Passenger cars have been moving at a rapid clip, with no one type clearly a favorite. Some dealers are disappointed with the short margins and slim profits they've pulled on their heavy volumes. Many are dubious that such high sales levels can be maintained through the fall. One director has already noticed a "drastic slowdown" in his area.

Because of good sales prospects, businessmen plan to accelerate their stock building through the summer, according to one director. Retailers seem more cautious in their buying for fall and spring 1979, says another.

Judging from the recent volume of announcements of new plants, capital expansions, and relocations, nonresidential construction activity and building materials production should be quite strong for several months.

In Florida, a number of huge, long-term residential developments, many backed by Canadian, Latin American, or European money, have emerged from the planning stages. Forecasts of a condominium shortage on the Gold Coast by year-end have become common.

Demand for consumer, mortgage, and business loans continues vigorous and has contributed to a rapid run-up of interest rates, particularly local prime rates. An economist for a large Florida holding company commented on the number of "marginal" business borrowers who have "come out of the woodwork." His organization feels it can be rather selective and still make all the loans it wants (it's also planning for a "rather severe" recession within the next few months).

Deposit inflows can still be characterized as moderate at most banks and savings and loan associations. Updates on the six-month CDs suggest that they are indeed drawing funds largely from passbook savings, bringing in roughly one-third new money. There have been a few more reports of S&Ls having trouble meeting loan demands--they've either quit accepting new applications or pushed back commitments to the fourth quarter, when they expect funds to be more adequate.

Prices of cattle and calves have been steady to slightly lower since late May. The near-term outlook is for continued leveling, but live prices may yet fall to forestall further increases in retail beef prices, which have already met resistance from consumers. Heavy marketings continue to delay the rebuilding of cattle herds. Broiler placements are expanding rapidly in response to increasing prices. Most crop prices have weakened in recent weeks. A dry spell in the eastern part of the District has been threatening growing crops; in the western area, weather conditions

have improved. The shift to soybeans has continued, with producers in some areas bidding up rents and drawing land out of pasture to expand acreage. A labor shortage in central Florida has left nearly 10 percent of the orange crop still on the trees and forced early closings of several concentrate plants. Unmanageable harvest costs, strong competition from Mexican produce, and mediocre crop quality have prompted some south Florida vegetable growers to open their fields to public harvest.

Businessmen continue to be most deeply troubled by inflation and what they perceive to be a lack of effective government measures to restrain it. In August, 11,000 Southern Bell employees will receive a 7-percent "cost-of-living" pay raise.

SEVENTH DISTRICT - CHICAGO

Except for housing, virtually all sectors of the Seventh District economy are vigorous and there is no evidence that momentum is fading. Farm equipment sales picked up briskly in the second quarter. Employment continues to rise, and unemployment to fall, throughout the region. Consumer spending on goods and services has remained at high levels. Prices appear to be rising at a faster pace. Capital goods overall are trending upward. Rising non-residential construction will provide an offset to the growing slowdown in residential construction.

Prices of goods and services are rising at a faster pace under the impetus of strong demand and rising costs of labor, transportation, utilities, insurance, and purchased materials. There has been no sudden surge in inflation, but rather a gradual acceleration with price increases posted more frequently than in the past.

Except for various building materials and certain special items, components and finished goods are available on normal terms. Delivery schedules have stretched out, but not to an alarming degree. Equipment producers, however, complain of long waits for large and special castings, as opposed to standard castings produced in quantity. Many smaller foundries have been closed in recent years, because owners were unable or unwilling to invest the funds needed to meet state or national EPA standards.

Retailers were pleasantly surprised by a surge in sales in the second half of June. Virtually all lines sold well for the month as a whole, including motor vehicles, appliances, home improvement items, and apparel. Consumers continue to use instalment credit freely. One large retailer reports a

moderate, but not serious, rise in delinquencies in recent months. Airline passenger traffic has been running about 15 percent above year ago with capacity loads on many flights. Cut rate fares have helped. A major telephone company reports net new installations of phones 50 percent above year ago, and message volume up 13 percent.

Employment in both the goods producing and service sectors has continued to rise at a surprising pace. Surveys of employers indicate further growth in hirings in the months ahead. Help-wanted ads in Chicago papers have been running about one-third above the year earlier level in recent weeks. Demand for executives is at the highest rate in a decade, according to a large recruiting firm. Many of these job openings are for engineers, accountants, tax lawyers, and others with highly specialized skills.

Recent contract settlements with construction trades unions in Chicago and Milwaukee have brought "moderate" first year increases in wages of 7 to 8 percent. Total compensation of electricians, iron workers, pipefitters, and operating engineers is now in the \$15 per hour range.

While most firms are hiring new workers, some major companies are currently pressing programs to reduce white collar staffs to raise average productivity and improve narrow profit margins. Such cost-cutting programs have been instituted despite good gains in shipments and orders. Examples include producers of paperboard, capital equipment, chemicals, and furniture.

Backlogs of steel orders indicate a high level of shipments through the third quarter at least for most plants in the region. A growing share of shipments consists of plates and structurals used in capital goods. Steel companies were "shocked" at the continuing high level of steel imports in April and May. The effect of trigger prices is still uncertain. An overhang

of inventories of imported steel in the distribution channels may prevent further price boosts, and possibly dampen domestic steel shipments in the fourth quarter. Chicago area plants are said to be the best situated in the nation to meet foreign competition.

Improving farm income prospects have encouraged farmers to spend more freely on equipment. Farm equipment sales had been very weak in the first quarter, but picked up in April, May, and June.

Demand for producer equipment, overall, has risen at a steady if unspectacular pace. Earth-moving equipment has been strong all year. Demand for commercial airliners, locomotives and freight cars, and heavy trucks and trailers is booming. The European "airbus," using many domestic components, appears increasingly attractive to US airlines because of its low operating cost. Delivery schedules for freight cars have stretched out to mid-1979. Shortages of freight cars are the worst in a decade, with priority given to grain movements. In part, the rail car shortage is blamed on bad management by Conrail. Very strong sales of heavy trucks currently may reflect, in part, diversion of traffic from rail to truck, and there are fears that a reaction may occur in 1979.

Residential building permits and sales of existing homes have been running 30 to 40 percent below year ago in major centers in recent months. Mortgage lenders have reduced new commitments sharply. Preliminary samplings indicate that S&Ls have gained a sizable net inflow of funds through sales of T-CDs, and this may improve the supply of mortgage funds. Little interest has been shown in the new 8-year notes. Nonresidential construction, especially commercial and industrial projects, is rising and the trend probably will continue into 1979.

EIGHTH DISTRICT -- ST. LOUIS

The Eighth District economy continues to advance, but at a more moderate rate than in April and May, according to a number of businessmen reporting on conditions in the area. Department store sales continue up slightly. Manufacturing activity showed strength in recent weeks in a number of important industries, but representatives of several firms expect some slowing in the second half of the year. Inventories remain at moderate levels. Credit demand has been strong in recent weeks and interest rates have continued to advance. Savings flows have remained at the slower pace of recent months; however, some S and L officials expressed the view that the new higher-yielding CDs will help them retain funds which otherwise would move to higher-yielding investment alternatives.

Retail spending at department stores made only modest gains in June. One retailer noted that sales were about as planned in recent weeks, but that targets have been lowered from those of a few months ago. Wearing apparel items were reported to be selling better than earlier in the year. Sales of some big-ticket items, such as freezers, ranges, and tires, were reported to be sluggish, whereas air conditioners and consumer power tools were registering gains. Automobile sales have remained strong and dealers are now clearing inventories for the new models. Dealers are generally optimistic about sales prospects for the new model year.

Manufacturing activity in major industries, such as transportation equipment, appliances, and chemicals, remains strong in the District. Appliance manufacturers noted that orders have continued up in recent months, rising to 10 percent above a year ago. However, representatives of appliance

manufacturing firms are quite cautious about sales prospects for later this year. Chemical industry representatives noted continued overall gains in June, although rubber sales have slowed. Some deceleration in the growth of chemical sales is expected in the summer months. A paint and coating firm has experienced strong sales gains since May, after sluggish sales during the early spring.

Homebuilding remains at a high level, and housing permits are at about the same level as last year. Yet, builders indicate some slowdown in new home sales which is attributed to the higher interest rates and more restrictive lending policies of the mortgage lenders. Realtors report that the demand for older homes continues strong, citing lack of listings as their main problem.

Credit demand continues to expand as indicated by sharply increasing loan volumes and higher interest rates. Banks and S and Ls report continued rapid increases in business loans, consumer installment loans, and real estate loans. Interest rates have continued to advance, with the prime bank lending rate moving to 9 percent and the most common home mortgage rate (80 percent loan) rising to 9-3/4 percent. With the higher rates, state usury laws are becoming an important factor in the credit markets in Missouri and Arkansas. A 10 percent usury law has caused lenders in these states to restrict lending to the less risky customers. Arkansas bankers report more restrictive lending policies on loans to small businessmen and real estate developers.

Inflows of funds into financial intermediaries continue at the slower pace of recent months. Large commercial banks have experienced losses in small passbook deposits, but increases in other time deposits have been

fairly rapid. The new six-month certificates have been gaining acceptance by consumers and some savings and loan officials expressed optimism that this source of funds will help avoid serious disintermediation. Currently more than 50 percent of the new CD purchases are made by withdrawals from existing accounts.

Crop plantings, while somewhat later than usual, are nearly complete in the District except for a portion of the soybean acreage which will be planted after the wheat harvest. Soil moisture conditions are generally reported to be adequate.

NINTH DISTRICT - MINNEAPOLIS

Business remains brisk in the Ninth District. Manufacturing, building, farming, and retailing sectors have maintained their heady pace of the past few months. And according to our Bank's directors the near-term outlook is marred only by a likely homebuilding slowdown brought on by sharply rising homeownership costs. The severity of that slowdown should be tempered by growing sales of the money market CD introduced in June.

In last month's Redbook summary we reported good news for just about every sector of our district's economy. Since that time little has changed. Our Bank's directors tell us that manufacturers, builders, farmers, and retailers across the Ninth District are doing well.

Manufacturing employment is up a healthy 5 percent from last year. And directors characterize industrial activity as being either "good" or "strong" in every district state.

Among the busiest manufacturers are those producing building supplies. They have been straining to keep up with the demands of the district's construction sector. Both residential and nonresidential builders have shared in that sector's hectic pace.

Farm businesses have also had their share of good tidings. Livestock prices remain quite high. And with the exception of some rain-damaged corn fields in southern Minnesota, crops are growing well throughout the district.

Directors from Montana and North Dakota report that the improved farm situation has spurred sales of high-priced farm implements. And

"big ticket" items are selling well off the farm too as low real rates of interest make consumer durables among the best investments available to most households.

Retailers have pursued cautious inventory policies in the face of this strong demand. They apparently have been concerned about the sustainability of the current brisk sales pace.

But currently available data does not lend support to the view that a slowdown is imminent. Econometric analysis of the region's economy carried out at this Bank indicates that retail sales will maintain steady growth through the remainder of the year. Manufacturers surveyed by our Bank expect year-over-year sales growth of around 15 percent in the third and fourth quarters. Crop farmers look for bumper harvests and price supports to boost this year's income well above last year's. And livestock prices are expected to remain relatively high through the remainder of the year so ranchers are in pretty good shape despite the recent relaxation of beef import quotas.

But observers aren't optimistic about every sector. It is feared that high building costs and rising interest rates will choke off the currently high rate of construction activity. Directors have mixed opinions regarding the near-term outlook for commercial building. Most say it is picking up but one Wisconsin director sees signs of a slowdown. They are unanimous in predicting a slowing of residential construction activity though.

This vulnerability of homebuilding is at least partly due to government-imposed market imperfections. For example, South Dakota has a 10 percent usury ceiling which is starting to interfere with the

operation of mortgage markets there. And the lure of high nominal rates of return on non-Regulation Q limited investments has slowed the flow of funds into banks and thrifts.

The T-bill rate six-month CD introduced in June has helped staunch a funds outflow though. Bankers in the region report that sales of these certificates have picked up substantially during June and early July.

TENTH DISTRICT—KANSAS CITY

Continued growth without severe imbalances characterizes Tenth District economic activity. Inventories of manufacturers' inputs and of goods in retail stores are considered to be close to desired levels. Lead times on some materials and producer goods have stretched out, but a slower rate of economic expansion is expected to hold production under capacity, thereby keeping supplies adequate. The wheat harvest is now slightly less than half-completed. Reports on yield vary, but total production will be down from last year in any case because of reduced acreage. The combination of large carryover stocks and government support programs should keep wheat prices fairly stable over the 1978-79 marketing year. Loan demand is strong and deposit growth is moderate at Tenth District banks. The demand for money market CD's is weak, and consists mostly of transfers from other time accounts.

Consumer spending continues strong, judging from reporting retail department stores. Softline items are selling especially well. Prices are up about 2 per cent, on average, from 3 months ago. Store executives complain about the exorbitant price increases being demanded by some manufacturers, and attribute this pricing behavior to expectations of price controls. Inventories at retail are felt to be a little high, but stocks are expected to be back to desired levels soon. Retailers forecast a slowing economy and stiffening competition for consumer dollars as the Christmas season approaches.

Purchasing agents say that input prices continue to rise and that lead times for some items are lengthening. However, inventories of materials remain satisfactory and no acute shortages of supplies are expected to develop in the months ahead. Most buyers note that business is good now,

but some think it might sour soon. In most of the firms represented by those purchasing agents contacted, there is still excess capacity. The aircraft industry in Wichita, however, is having trouble hiring and retaining skilled labor and management personnel.

Hot, dry weather has permitted wheat farmers to harvest their crop at a rapid clip, although total progress is somewhat behind schedule. The harvest is finished in Oklahoma and is progressing well in Kansas, but the 40 per cent that has been harvested compares with a long-term average of 55 per cent for this point in time. Reports on yields are mixed. With the reduction in acreage, production will obviously be smaller than last year. Moreover, most of the information in the press indicates that yields may fall below levels projected by the USDA. However, two directors report that yields in their immediate areas are excellent. No matter what the final production figure is, carryover stocks are sufficiently large to assure an abundant total supply of wheat for the 1978-79 marketing year, which will likely preclude a sharp runup in wheat prices over this period.

The two directors commenting on the wheat harvest agree that most of the harvested grain is finding shelter, despite well-publicized concern about a boxcar shortage 1 to 2 months ago. As always, some grain is being temporarily stored on the ground or in the streets of rural communities. Within a short time, virtually all of this wheat will find shelter as local elevators begin shipping to terminal markets. Although a seasonal decline normally occurs during the harvest period, wheat prices have held up very well so far this year. Given the quantity of grain that is under Government loan, together with other features of the farm program, it is unlikely that wheat prices will experience the same precipitous drop as occurred last year.

Thus, 1978 should be a better year for the District's wheat producers.

Tenth District bankers report that loan demand remains strong. A number of bankers single out loans for energy and natural resources development as one of the strongest loan demand categories. Agricultural loan demand, particularly by cattle farmers, is heavy. Construction loan demand for single-family housing also remains vigorous. Some banks report that they are becoming somewhat more selective in making loans due to the continued strong demand and a slight tightening of available funds. Most bankers expect their lending rates to peak within 6 months, with a prime rate reaching between 9 1/4 and 10 per cent.

Deposit growth is moderate at most banks contacted. Demand and time deposits are increasing, but passbook savings deposits are leveling off or declining due to withdrawals by corporate customers. Money market CD's are being offered by all banks contacted, but the demand for them at most banks has been weak. Almost all of the money market CD's consist of transfers from other time accounts. Some bankers feel that the money market CD's may help to divert a slowdown of deposit growth.

ELEVENTH DISTRICT--DALLAS

The fast pace of economic growth that began in early spring continues, but a slowdown in business activity is forecast by fall, according to the Directors and businessmen surveyed this month. Department store and new car sales are well above year-earlier levels, and manufacturing output--led by durable goods production--continues to grow steadily. Business inventories are being closely managed, and there is little evidence of inflation hedging. Savings inflows to S&L's are slightly improved, but the strong demand for mortgages is keeping that market tight. Bankers indicate they can meet projected loan demand even though deposit growth continues to slow. Agribankers report farm loans remain strong, but repayments are slow and loan renewals and extensions are frequent.

Retail sales are growing at an unsustainable rate, according to survey respondents, and a slowdown from the current strong pace is expected in coming months. Department store sales are running 15 percent ahead of year-earlier levels, and much of the strength is attributed to advanced buying in anticipation of higher inflation. Several auto dealers report record sales levels for new cars, while the market for used cars has softened. Foreign car dealers continue to report their sales are being held down because they are unable to get a sufficient number of new cars. Many sales are being made because buyers realize prices for current models are likely to be much less than for the 1979 models. Therefore, dealers expect new car sales to slow when this model year comes to an end.

There has been little change in the steady rate of growth in manufacturing output this summer. Most of the strength continues to be

centered in the durable goods industries. Producers of cement, aluminum, and fabricated metal products are operating at full capacity. Business for aircraft manufacturers is also on the rise. General Dynamics has begun full-scale production of the F-16 fighter plane, which will raise employment at the Fort Worth plant through 1980, and Bell Helicopter reports growing sales for its civilian aircraft. Although the firms indicate that there are tight supplies of aluminum, titanium, and avionic components, the effects of the shortages have been dampened by careful planning and early ordering. In nondurable goods manufacturing, apparel firms are operating at 80 percent of capacity. Summer sales are up, but a decline is anticipated by fall. Apparel manufacturers are having difficulty passing on price increases, and profit margins are squeezed.

Businesses are maintaining close control over inventory levels, and stocks at most trade and manufacturing establishments are reported near desired levels. Expectations of higher prices are tempting some businesses to hedge their inventory positions by making advanced purchases, but the higher costs of financing inventories and the increasing concern of a recession are prompting many firms to hold down inventory levels and not to hedge against inflation.

Savings inflows are slightly improved since May at District S&L's, even though the rates of inflow are down as much as 50 percent below year ago levels. Deposit gains are particularly strong in the Dallas-Fort Worth area. Some of the improvement is due to the marketing of the new six-month money market CD's. S&L's report that 40 to 60 percent of the new issues represent new deposits. Despite the small improvement in deposit flows, there appears to be no letup in the demand for mortgages. The size of

mortgage loans continues to be increasingly restricted to 80- and 90-percent loans with the mortgage rates bumping up against the 10-percent usury ceiling.

Lending activity at commercial banks continues to climb with demand expected to remain strong for the rest of the year. All categories of loans are contributing to the growth with petroleum and real estate loans leading the advance. Although deposit growth continues to slow, most banks report their liquidity positions are adequate to meet projected loan demands. There is, however, a growing number of banks reporting tight liquidity positions. Large denominated CD's remain the primary source of deposit growth at large reporting banks, while six-month money market CD's are contributing little to overall growth.

Demand for agricultural loans remains strong, but repayments are slow, and loan renewals and extensions are frequent, according to our latest survey of agribankers. In addition, the number of referrals to nonbank credit agencies continues to rise. Demand for feeder cattle, crop storage, and farm operations is expanding, and the demand for farm machinery is improved. A third of the respondents consider their loan-to-deposit ratios are too high, compared to less than a fourth of the bankers three months ago. Most farmers continue to be in worse financial condition than a year ago. Some improvement, however, is noted in Oklahoma and East Texas, while dry weather continues to hamper farmers elsewhere in the District.

TWELFTH DISTRICT - SAN FRANCISCO

Consumer spending remains strong in the West, with autos displaying considerable briskness. For various reasons, several western industries anticipate capital spending to be less than that needed to meet future demand for their output. Housing demand appears to have been dampened somewhat by high interest rates, though a number of savings institutions do not have the funds to meet even this weaker mortgage demand.

Retail sales continue strong in the West. The consumer is still the strong factor in the California economy, according to one director. Comments from Washington, Oregon and Utah echoed this sentiment. Auto sales have been particularly brisk -- enough to offset softness in the sales of other consumer goods in some areas. Sales of household durables, in particular, are said to be growing less rapidly than last year in southern California. There seems to be a growing feeling that retail sales will not continue their current strength for very much longer. One banker-director noted that consumer debt burdens are already too high to permit a continued expansion of debt-financed retail sales.

One large clothing manufacturer plans to cut back inventories in anticipation of slower retail sales in early 1979. A large distributor of domestic and foreign cars reports low inventories right now because they are selling more cars than they can get their hands on.

The economic recovery continues, according to Seattle University which is finding more demand for its graduates this year than last. Demand is particularly strong for bachelor's degrees in engineering and business and for MBA's. Demand is weak for graduates in liberal arts and education.

In the industrial sector of the West, a number of businesses note that their planned level of investment is insufficient to meet the expected demand for their industry's product. The president of Kaiser Aluminum noted that "investments have lagged in the industry due to inadequate returns in prior years and due to uncertainties caused by inflation". A large clothing manufacturer stated "the clothing industry is a low-wage business and the increase in the minimum wage is forcing us to look at outside sources (imports), rather than local investment and expansion". An oil producer pointed out that oil companies are concentrating their capital investments offshore and that no new-technology refineries had been built in the U.S. for many years. A gas producer supported this by noting that gas supply projects are difficult to finance because of the low return on investment capital. He felt that the rate of return was held artificially low by the regulatory lag and the lack of a well-defined energy policy.

The exception to this trend appears to be the banking industry. Several banker-directors noted that investment in new capacity has been sufficient to support continued expansion of that industry. However, one director did say "it is likely that investment in new facilities will moderate during the next eighteen months in line with our forecast of reduced growth in major loan and deposit categories".

There seems to be a general consensus that construction activity peaked in the fourth quarter of last year and that the demand for home ownership has been dampened by both high mortgage interest rates and uncertainty over whether the California property tax cuts promised by Proposition 13 will really be forthcoming. Building permits have declined since the first of the

year in several counties of southern California and quite substantially in at least one case (47 percent in Orange County). However, there are still several areas (such as Oregon) where construction activity is quite strong.

Concern was expressed by a number of directors over high interest rates and a lack of funds for mortgage lending. Several S&L's have stopped making loans and at least one other has reduced the maximum amount of a loan. A Utah banker saw a lack of mortgage funds in both primary and secondary markets. One small bank noted that the new T-bill Certificates had stimulated very little activity. Consumer lending remains brisk, but the feeling seems to be that consumer debt burden may have reached its limit.