

SUMMARY OF COMMENTARY ON CURRENT ECONOMIC CONDITIONS
BY FEDERAL RESERVE DISTRICTS

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SUMMARY*

Economic expansion continues at a pace varying from sluggish in two Districts to moderate or strong elsewhere. Employment levels are stable or rising, with tight labor market conditions noted in some areas. While retail sales are generally lackluster, auto sales have picked up. Manufacturers report moderate to healthy gains in sales and orders, although four Districts note signs of a possible slowing. Capacity constraints and shortages have developed in some Districts and materials price increases are widespread. Construction activity is mixed, with home construction reported to be weaker than nonresidential building. While the impact of this summer's drought varies, even within states, the corn and wheat crops have suffered extensive damage. The recent rains may save much of the soybean crop, however.

Consumer Spending

Most Reserve Banks find retail sales to be sluggish, with only Atlanta and Minneapolis reporting any real vigor. Respondents cited apparel and furniture sales as particularly weak; moreover, the rising cost of imported clothing has reduced margins as well as sales volumes. Inventories, however, are said to be in balance: only in the Cleveland and St. Louis Districts were buildups reported. Boston and San Francisco retailers attribute this healthy inventory situation to careful monitoring: retailers in New York, Philadelphia, Cleveland, and St. Louis, are reportedly resorting to heavy promotions to clear the shelves.

* Prepared at the Federal Reserve Bank of Boston and based on information gathered prior to July 26.

Retailers expressed mild optimism about the next six months, with those in the Atlanta, Minneapolis, Richmond and Dallas Districts expressing greater confidence in the future than merchants in Philadelphia, Cleveland, Kansas City, and St. Louis.

In marked contrast to general retail conditions, many Districts characterize auto sales as strong and above dealer expectations. Only Richmond finds car sales declining. Domestic makes, aided by manufacturer incentives, are said to be moving briskly. Foreign autos, by contrast, are reportedly rising in price and languishing in the showrooms. San Francisco finds inventories of unsold imports now standing at "unsustainably high levels."

Manufacturing

Manufacturing sales and orders continue to grow at a moderate to healthy pace in most Districts. Respondents credit manufacturers' investment and export activity for much of this growth. While contacts in Philadelphia and Dallas see some pick-up in demand from earlier months, Boston, New York, Richmond and San Francisco report recent signs of slowing. Strong sectors include steel and other primary metals, machinery - particularly machine tools - fabricated metals, commercial aircraft and railcars. Atlanta and Chicago also see strength in autos, tires and some other consumer goods. Among the weaker sectors were agricultural equipment and most defense goods, as well as energy-related and construction-related products.

Increases in the prices of such materials as metals, paper and food were widely noted. While a few contacts expect these prices to stabilize, more think they will continue to rise. Kansas City, Cleveland, Richmond

and San Francisco report that shortages of steel, valves, castings, motors and chemicals have developed. Cleveland, Dallas and San Francisco also mention capacity constraints, especially in petro-chemicals and pulp and paper. In this environment, manufacturers are reportedly choosing to hold higher inventories and are finding it easier to raise their own finished goods prices.

Manufacturing employment is generally stable or increasing slightly. Cleveland and Philadelphia report healthy gains while Atlanta and Boston report recent layoffs. Most contacts foresee little or no acceleration in wage pressures. San Francisco respondents were evenly divided on this issue, however, and Dallas and Minneapolis noted some industry-specific pressures.

Construction

Residential construction is down from year-ago levels, although the Richmond District reports strong housing construction and sales. In the San Francisco District residential building is very healthy along the coast but weak in some of the inland states. Richmond, Atlanta, Minneapolis and Kansas City also observe substantial variations in the strength of housing sales and construction within their districts, with larger cities experiencing stronger activity than more rural areas.

Reports on nonresidential construction and real estate activity were positive for the most part. Although nonresidential construction contracts were down from a year ago in the St. Louis District, office building construction has surged in some cities in the Atlanta District and leasing has picked up in New York. Office building construction has slowed

somewhat in Chicago, but remains at a high level; industrial real estate and construction activity in the District has strengthened. Dallas reports that both nonresidential and residential construction contracts have stabilized, a development suggesting that a prolonged downturn in construction may be at an end.

Agriculture and Natural Resources

The impact of this summer's drought varies considerably by crop - even within a given state. In the Kansas City District, winter wheat matured on time and the harvest was normal, but in the Chicago and Minneapolis Districts recent rains were too late for the spring wheat, barley, oats and hay. The July rains were also too late for much of the corn crop. In some parts of the Kansas City, St. Louis and Minneapolis Districts, corn yields are expected to be down 50 percent or more. However, if the recent improvement in the weather holds, Chicago, St. Louis, Atlanta and Minneapolis suggest that the soybean crop could recover to near normal levels. Cotton, rice, sugar cane, peaches and citrus fruits are also in good shape, but the state of vegetable crops varies. In the Chicago District (an important source of processing supplies), vegetables were severely damaged, but in Atlanta the crop is satisfactory. While ranchers have sold more animals than usual and cattle prices have fallen, no large-scale liquidation has occurred. Instead, according to reports from Dallas, Atlanta and Kansas City, record numbers of cattle have been put on supplemental feed; as a result, ranchers' profits will be squeezed. Nevertheless, the Kansas City and Minneapolis Districts point out that improvements in the financial positions of farm borrowers and lenders over the last two years will help most withstand the impact of the drought.

Atlanta reports that demand for forest products has weakened recently with the slowdown in building activity, while San Francisco sees no such decline. Both are experiencing strong export activity.

With the price of oil below \$15 per barrel in mid-July, Atlanta finds oil production slipping and Dallas and Kansas City report or expect a fall in the rig count. Atlanta and Richmond see coal output rising with help from the weak dollar and strength in steel.

Financial Activity

Except in the Dallas District, loan demand is healthy. Business lending is reported to have accelerated in the Philadelphia and Atlanta Districts, while consumer lending has grown vigorously in Cleveland, Kansas City and San Francisco. In the Cleveland District consumer installment loans have recently increased at an annual rate greater than 50 percent. Consumer lending is said to be rather weak in the Philadelphia and New York Districts, but demand for home equity loans remains very strong. New York respondents also note that delinquency rates on consumer loans are equal to or lower than year-ago levels. Reports on commercial real estate lending are mixed, with Cleveland reporting relatively strong growth and Atlanta and Philadelphia seeing some tapering off.

Richmond bank executives report substantial increases in deposits in July; Philadelphia bankers have also seen a pickup. In the Dallas District, however, deposits and assets - particularly business loans - both continue to decline.

FIRST DISTRICT-BOSTON

Retail sales in the First District ranged from fair to "OK" in recent weeks with early July somewhat weaker than June for most stores. Retailers have kept inventories in line without extensive markdowns and margins have not eroded significantly. Manufacturers report a good first half, with profits rising more than sales. Prices of both inputs and finished goods are generally rising faster than a year ago, with selected commodities and imports leading the way. The outlook for the rest of 1988 and the first half of 1989 remains positive, but recent signs of weakness have generated some concern.

Retail

Sales are running at or below planned levels in many First District chains. Planned levels varied widely, however, from 5 percent to more than 20 percent ahead of last year. All but one of the merchants contacted reported slower growth in early July than in June; the exception experienced some pickup after several months in the doldrums. Respondents carrying ladies' apparel described this area as weak; several attributed their problems to the failure of short skirts to catch on. Hot weather makes it difficult to assess consumer interest in the "more traditional" transition and fall apparel now available, but merchants expect a good response.

Most contacts reported that careful monitoring had kept inventories from getting too high. While some markdowns have been taken, the careful control of inventories has enabled contacts to avoid extensive price-cutting and hence to maintain margins.

Price increases are averaging about 5 percent overall. All contacts noted that price increases are greater this year than last. Rising import prices have caused merchants to seek out alternate foreign and domestic suppliers. Wage costs are also rising in the region, as retail employers attempt to deal with high turnover and the tight labor market.

Sales in the remainder of 1988 are expected to increase 5 to 20 percent compared to 1987. This range is similar to actual results to date, but merchants seem cautious. One mentioned a lack of exciting new products; others lamented female customers' reluctance to buy. Store openings and remodelings proceed on schedule, however, and several contacts said they could scale up quickly if sales are more buoyant than expected.

Manufacturing

For most First District manufacturers the first half of 1988 proved "very good," even "a boomer to date." Sales in the first half were up 5 to 15 percent from year-ago levels while profits rose even more. New orders increased 3 to 20 percent. Respondents experienced strong demand from a broad range of customers, including makers of commercial aircraft, autos, machinery and sports equipment. The only weak markets were construction and military aircraft. Despite these strong results, half the respondents noted very recent (May or June) slowdowns in sales, orders or responses to marketing efforts. While all the declines could be explained away, these signs of possible weakness introduced a note of caution.

Reports on inventories were mixed. Half of the respondents said inventories were comfortable while half found them a little high. Two mentioned that the longer lead times required in ordering paper had contributed to larger inventories.

Three-fourths of the manufacturers noted big price increases for basic materials such as steel, copper, aluminum and paper. A few thought that metals prices had stabilized, but most foresaw continuing upward pressures on commodity prices and cited increases already announced for August and September. Most manufacturers could pass on at least part of these rising costs. While price increases have become "more acceptable," in some markets competition still makes them difficult; thus, manufacturers' price increases ranged from "very little" to "10 to 15 percent and sticking."

Many contacts described labor markets as tight, with technical workers and minimum-wage teenagers said to be in particularly short supply. However, most respondents do not sense that wage pressures are picking up in the manufacturing sector. Workers continue to give priority to job security and preserving work rules rather than to wage gains. In general, contacts report that employment levels are stable or up slightly, but according to press accounts, two major regional employers have recently announced lay-offs.

Most First District manufacturers characterize their capital spending programs as "strong." Expenditures for 1988 range from slightly less than last year's level to increases of 20 percent. Capital programs continue to emphasize cost reduction, productivity gains and replacement needs, but three firms are expanding their U.S. capacity.

Expectations for 1988 as a whole fall between "OK" and "good." Sales and profits are generally forecast to end above last year's levels. Nevertheless, half the respondents noted recent signs of weakness, and two expect a slowdown in the second half. Several contacts forecast a recession for late 1989, and half expect inflation to accelerate.

SECOND DISTRICT-NEW YORK

The expansion in the Second District economy seems to have slowed somewhat in recent weeks. The latest purchasing managers' surveys showed slightly fewer firms reporting stable to improved business conditions and retailers experienced lackluster sales. The pace of residential construction continues below the year-earlier level and demand for luxury housing is down. Office leasing activity has picked up, however. Most small- and medium-sized banks have not raised interest rates on consumer loans since the prime rate increase.

Consumer Spending

Sales at District department stores have continued sluggish since the last report. May was especially weak with over-the-year sales changes ranging from -5 percent to +2 percent. Although June brought some improvement, year-to-year sales results of -1.4 percent to +8 percent were all below respondents' targets.

Various kinds of apparel were cited as problem areas in recent weeks. Sales of women's apparel remained poor and sales of young men's sportswear were soft as well. In addition, furniture sales were down from a year earlier. Accessories, cosmetics and housewares moved fairly well, however. Inventories are comfortable for the most part, due to heavy promotional activity. Retailers do not anticipate much improvement for the rest of the summer but are cautiously optimistic about the fall season and the new fashion lineup.

Business Activity

Some slowing of the District's economic expansion occurred in recent weeks. In both Buffalo and Rochester the percentage of purchasing managers reporting improved business conditions declined and the percentage reporting a worsening increased. Nonetheless, by far the majority of firms--95 percent in Rochester and 79 percent in Buffalo--report stable to improved conditions. Inventories were generally satisfactory following a paring of stocks by some Rochester firms with unintended accumulation.

Foreign corporations figured prominently in recent District developments. Groundbreaking ceremonies were held in New Jersey for the U.S. headquarters of Jaguar Cars, Inc. and, in its second major expansion project in New York in two years, Swiss Bank Corp. bought a 27-story building in lower Manhattan to house a training center as well as headquarters and offices for some of its U.S. operations. In addition, a Japanese firm announced that its new U.S. subsidiary will begin producing printer ribbons on Long Island, and a subsidiary of a Swedish company plans a \$10 million capital expansion in Utica.

Residential Construction and Real Estate Activity

The pace of homebuilding activity in the Second District generally remains somewhat slower than a year ago. Most pent-up demand has already been met and buyer resistance to the high level of new home prices has been noted in several areas. A few upstate communities report strong buying and high levels of residential construction, however. While demand for luxury housing has slowed somewhat, a number of projects to provide more affordable housing in the New York metropolitan area have recently been started or announced. Work was begun this spring on a new, 1,200-unit, middle-income townhouse complex in the Bronx, the largest low-rise

development ever undertaken in that borough of New York City. On Long Island in an area where 430 moderate-income units are already being built, plans are being finalized for 600 more moderately-priced single and two-family homes on the site of a former, large state hospital complex. Finally, in Brooklyn some 300 low-income, low-rise units are being built under a new New York City tax abatement program for private developers of such housing.

A pickup occurred in commercial real estate activity. Westchester County witnessed one of its largest transactions in the past two years when a communications company purchased a large office building in order to expand operations there. Elsewhere in that county, brisk leasing was reported at an office park which is under construction. The signing of several large transactions boosted office leasing activity in midtown Manhattan recently, and some signs of stabilization were noted in downtown Manhattan as well. Finally, what is reportedly the largest office lease ever taken by a Japanese firm in the U.S. was signed at the \$10 billion Newport City mixed-use project under construction in Jersey City.

Financial Developments

A survey of small- and medium-sized banks in the Second District indicated that most have not raised interest rates on loans to consumers since the July 14 increase in the prime rate. Though some officers anticipate that their bank may raise mortgage rates, few expect an increase in rates on consumer installment loans. One banker commented that interest rates on consumer loans generally fluctuate much less than those on home mortgages. Nearly all respondents anticipate rising market interest rates in the second half of 1988, though some predicted only minor increases. Most bankers said the current market for auto and other consumer

installment loans is rather weak, with demand either flat or down compared with last year. Those with an increase in applications noted that their banks had recently mounted aggressive marketing campaigns. Several bankers mentioned that home equity loans have eroded the popularity of conventional consumer financing due to the Tax Reform Act of 1986 and the demand for them continues very strong. Delinquency rates on consumer loans have remained steady or declined from this time last year, and many respondents were pleased with the low delinquency rates on their loan portfolios. Demand for bank credit cards was described as good and comparable to last year. Some bankers believe future demand will not be as strong due to tax law changes reducing interest deductons.

THIRD DISTRICT - PHILADELPHIA

The Third District economy is continuing on a moderate expansionary trend in July. Manufacturing activity is growing modestly and area firms are adding to payrolls. Retailers report a slight pickup in sales after a May-June lag, and auto dealers say sales are running above expectations. Bankers report that demand for business loans improved in June and is continuing to grow in July, but they say consumer loan growth is being maintained only by easier credit terms. Home equity lending remains strong, however. Bankers also note a pickup in deposit growth during June extending into July that is easing pressure on their cost of funds.

Most business contacts in the Third District look for a continuation of current trends through the end of the year. Manufacturers forecast further expansion in the next six months, and they plan additions to payrolls and increases in capital spending. Retailers expect sales in the second half to slightly exceed the same period last year. Domestic auto dealers believe sales will remain strong through fall but import dealers fear price increases will result in a year-to-year drop in sales. Bankers see the region's expanding manufacturing sector bolstering business loan demand but they expect little growth in consumer lending.

MANUFACTURING

The region's industrial sector remains on an upward path, according to the latest Business Outlook Survey. Twenty-nine percent of the firms participating in the July survey said business improved from the prior month, while only 5 percent indicated that business had slowed. Both durable and nondurable goods producers are experiencing moderate growth. On balance, area manufacturers

report increases in new orders that are being matched by higher shipments, leaving order backlogs virtually unchanged. Delivery times were increasing marginally in July, reflecting a step-up in the volume of business, but a slight inventory buildup indicates that area firms are more than able to meet rising demand for their products. Employment remains healthy: although most firms are holding payrolls steady, one-fifth of those surveyed in July were adding workers.

Price pressures in the industrial sector show no signs of abating. Half of the firms polled in July report higher input costs and one-fourth are raising prices on their own products. Looking to the future, 87 percent of the survey respondents expect to pay more for the goods they purchase in the next six months, and 65 percent plan to charge more for the products they make.

Looking ahead, area manufacturers see a continuation of current trends. Overall, firms polled in July expect business to expand further during the next six months. They forecast gains in orders and shipments, and some firming in order backlogs as well. On balance, survey respondents are planning to boost capacity over the next six months by hiring more workers and investing more in plant and equipment.

RETAIL

Third District retailers contacted in the second half of July reported a slight improvement in sales continuing from June. Based on comments from store officials, the current sales rate is running around 5 percent above the year-ago pace, in dollar terms. Hot weather has boosted sales of seasonal items, including summer apparel, according to local merchants. However, they also say they have been making more extensive price reductions in recent weeks in order to stimulate sales. The strong demand for seasonal goods and consumer response to discounts are bringing inventories down to more satisfactory levels.

Looking ahead, most retailers in the Third District say current trends give them no cause for pessimism, but they remain cautious in planning for the fall. The local consensus is for second half results somewhat above last year's. However, merchants say they are prepared to cut prices and cancel orders if there are early signs that consumer spending this autumn will be below their forecasts.

Auto dealers report a pickup in sales in June that has carried into July. Sales are currently running above their expectations, and dealers attribute much of the gain to manufacturers' rebate programs. Domestic auto dealers are optimistic that sales in 1988 as a whole will exceed 1987 sales. Import dealers indicate that foreign manufacturers who have not yet raised prices to fully compensate for the dollar's decline may do so later this year, and they believe this year's sales could fall below last year's as a result.

FINANCE

Loan volume at major Third District banks increased in June and bankers contacted in July generally report further growth in most categories of lending. Bank loan officers say commercial and industrial lending has been accelerating and is likely to remain healthy for the near future. Demand for consumer credit is not strong, although home equity loans are still popular; nevertheless, area banks have been able to increase installment lending by offering more attractive credit terms. Growth in real estate lending, while still at a healthy pace, continues to taper off, and bankers see this trend continuing.

Deposit growth at major Third District banks picked up in June, and bankers say this growth was being maintained in July. In particular, demand deposits appeared to be reversing the year-over-year decline of the last eight months. Bankers indicate that growing demand for business loans in combination with increased deposit growth is bolstering net interest margins.

FOURTH DISTRICT - CLEVELAND

Summary

The Fourth District's economy continues to grow. Ohio's unemployment rate fell for the fourth straight month to 5.9 percent as a result of employment gains in both manufacturing and nonmanufacturing sectors. Manufacturing firms report steady gains in production, new orders, and employment. Retail and auto sales remain sluggish. Banks report relatively strong growth in commercial and consumer installment loans.

Retail Sales

Retailers report sluggish sales, and they continue to be cautious about prospects for improvement in the fall. Furniture and appliance inventories are higher than a year ago, and stores have had to resort to considerable discounting of summer merchandise to trim large inventories. Merchandisers expect that rising interest rates will keep furniture and appliance sales soft in the months ahead. Retailers generally are ordering very cautiously for the fall because they expect to have difficulty passing through to their customers the large price increases being paid on imported goods, especially apparel. Retailers report that, where possible, they are shifting to domestic sources.

Auto dealers report that sales picked up in the last half of June but turned sluggish in the first half of July. Some suggest the early July slowdown is seasonal and will be reversed in the last half of the month. Recent minor adjustments in incentive programs seem to be having little impact on sales. Dealers generally see no indications that customers are becoming

less willing to spend, and one dealer reported that customers seem to be choosing more expensive models and options. Some dealers complained they have lost sales because inventories are too low while others expect to have difficulty clearing out some models at the end of the model year. Foreign cars continue to sell well.

Labor Markets

Labor markets showed broad-based improvements during the last several months. Overall, Ohio's unemployment rate fell to 5.9 percent in June, the lowest in the last several months. The decrease resulted from both a decrease of 10,000 unemployed workers and an increase of 23,000 workers. Much of the increase came from the service sector, especially business services, hotels, and recreation services. However, manufacturing employment has increased steadily, with durable goods employment showing strong improvement, particularly in the smaller cities. Recent employment projections indicate improved job prospects for these cities, which were recently severely affected by the decline in manufacturing. Most of the employment gains in the large urban areas were outside the manufacturing sector.

The average workweek for Ohio production workers increased by .2 hours in May to 43.2 hours. Weekly earnings were up \$2.84. The largest increases in earnings were in motor vehicles and equipment and blast furnace and basic steel products.

Manufacturing

Manufacturing in the Fourth District continues to rebound, with increases reported in production, new orders, and employment. Comments from purchasing managers in Cincinnati and Cleveland indicate that production levels are taxing capacity and that orders are being scheduled into next year. The increase in production and new orders continues to exert pressure on the prices and availability of a wide range of commodities, particularly bearings, electric motors, and a variety of chemical and steel products. The higher prices and the unpredictability of lead times have led some purchasers to increase raw material inventories. However, most businesses report that the high volume of new orders and the steady backlogs of existing orders should absorb the additional stockpiling.

Favorable exchange rates continue to benefit many industries in the region. For example, through the first five months of 1988, orders for machine tools have increased 83 percent from the same period last year. Raw steel production in the Youngstown, Pittsburgh, and Lake Erie regions rose 15.8 percent during the last three months over the same three-month period a year ago. Improvement in the steel industry has prompted several large steelmakers to modernize and expand existing plants in the District.

Banking

District loan demand has been quite strong. Total loans outstanding at large banks rose at an annual pace of 22 percent from mid-May to the beginning of July. Consumer installment loans, which grew at an annual rate of more than 50 percent, accounted for much of the overall loan growth. Nevertheless,

the demand for business credit and mortgages was also relatively strong with commercial and industrial loans growing at an annual pace of 11 percent and real estate loans growing at 13 percent.

FIFTH DISTRICT-RICHMOND

Overview

The District economy continued to expand through the first half of July but apparently at a slower pace than earlier this summer. Retail sales were generally firm but auto sales were weaker. Manufacturers reported moderate growth in activity, although some softening was noted in the demand for textiles and furniture. Producers continued to report shortages of raw materials and upward pressure on prices. Export activity was strong and import activity was mixed at District ports. Depository institution executives reported generally firm loan demand and increases in deposits. They expect interest rates to be flat to rising in coming months. District farmers welcomed the recent rainfall which has provided some relief to many drought-stressed crops.

Consumer Spending

District retailers responding to our regular mail survey reported higher sales in the first two weeks of July compared with the preceding two weeks. About half of the retailers reported increases in sales while 34 percent reported declines. Increased sales were reported at department stores and furniture stores while most car dealers reported a decrease.

Among department stores, sales of big ticket items were unchanged according to about 80 percent of the respondents while one reported an increase. Half of the department stores said their inventories declined compared with one-third who said their inventories were unchanged. Nearly 80 percent of the department store respondents expect sales to increase in

the next six months, while none expect sales to decline. In comparison, in our May survey, 56 percent expected sales to increase and 11 percent expected declines.

Tourism

With the exception of West Virginia, states in the District report that summer tourist and convention activity have been higher than a year ago. West Virginia's activity is reported to be unchanged from year-earlier levels. All states expect their tourist business to continue to improve.

Manufacturing and Coal

Manufacturing activity expanded in the first three weeks of July, according to our regular mail survey, although not as sharply as reported in our last survey. Thirty-eight percent of the respondents reported increased shipments, compared with 46 percent in the previous survey. Reports of reduced shipments increased to 23 percent from 12 percent. New orders, backlogs of orders, employment, and the length of the workweek increased, although at a slower pace. About three-fifths of our respondents reported no change in inventories of finished goods and materials, and about one-fourth reported increases.

Prices of inputs and finished goods continued to rise at about the same pace as reported in our previous survey. About one-third of the District manufacturers said they had raised the prices of their finished products, and two-thirds reported higher prices for raw materials. Almost half of our respondents reported difficulties in obtaining raw materials--especially steel and chemicals.

District manufacturers expect their businesses to expand further in the next six months. About 40 percent of the respondents believe their

shipments and new orders will rise, compared with about 15 percent who anticipate declines. The majority of producers do not plan to change their inventory levels in the next six months. One-third of the respondents, compared to about one-fourth in our previous survey, expect to increase capital expenditures in the next six months.

District coal production for the first half of the year is up about two percent from the first half of last year. Industry analysts say the decline in the value of the dollar and increased steel production has increased demand for West Virginia coal. These analysts foresee little effect of a decline in oil prices on coal demand because only a small number of domestic coal-fired electric power generators can be converted to oil.

Finance

In conversations with us, executives from several major Fifth District financial institutions indicated continued strength in their sector. Most institutions posted large increases in deposits in July. Generally institutions experienced modest increases in consumer and real estate loan activity through mid-July. The executives reported little change in loans for commercial construction, but the volume of these loans would have risen, they said, had their institutions not become more conservative in their lending policies. Bankers and thrift executives expect interest rates to hold steady or increase slightly over the next three to four months.

Housing

The District housing market remains strong according to a telephone survey of realtors and builders, and according to reports from our directors. Most of our contacts are optimistic about market conditions for single-family homes in the coming months. However, one realtor said

the current surge in sales may reflect buyer anticipation of higher mortgage rates in coming months, which could leave the market depressed this fall. On a down note, market activity in multi-family units is almost nonexistent according to our survey.

Ports

Representatives from the three major District ports--Hampton Roads (Norfolk), Charleston, and Baltimore--noted general increases in export shipments for June over May. The import picture was mixed, however, with shipments reported to be lower at Hampton Roads, higher at Baltimore and unchanged at Charleston. All ports expect strong export activity to continue during the next six months. Compared to a year ago, export activity was outpacing that of imports.

Agriculture

Recent rainfall across District states has brought some relief to crops, but more rain is needed, especially in the western portions of the states. Analysts believe the drought has reduced District corn yields, but expect most other crops to show only minimal damage if rainfall is normal for the rest of the growing season. The South Carolina peach crop, for example, is said to be one of the best on record. Hay conditions are poor, but as yet, District livestock liquidations do not appear to be above normal. Agricultural banks responding to our quarterly survey indicate that, as of June 30, demand for farm loans in the District were at normal levels and farm loan repayment rates were above average.

SIXTH DISTRICT - ATLANTA

The Sixth District economy showed signs of moderate expansion in June. Expansion in key manufacturing industries was tempered by layoffs in other sectors. Retail sales have picked up and recent dealer incentives have boosted auto sales. While residential construction has slowed, nonresidential construction and home sales are strong in major regional markets. Tourism is benefiting from increased convention activity throughout the region. Recent rainfall has improved prospects for crops and livestock in many drought-affected areas.

Employment and Industry Industrial activity has been mixed since the last reporting period. While the fabricated metals sector is experiencing a surge in exports, orders for energy-based equipment remain sluggish and the drought has hurt the sale of agricultural equipment. Appliance producers expect a noticeable falloff from last year's record setting pace as a result of the slowdown in housing starts.

Layoffs continue in the region's auto assembly plants, as well as at a large producer of military aircraft, and at Tennessee Valley Authority. Although defense spending remains under pressure, regional companies producing defense related electronic equipment continue to report favorable business conditions.

Plant expansions have been announced for the region's tire manufacturing industry as a result of strong demand. The carpet industry is doing particularly well in the replacement market. Carpet makers are concerned, however, that the drought may force them to cut back on their water intensive processes such as dyeing and finishing, possibly causing temporary layoffs.

Consumer Spending In June and early July retailers in much of the Southeastern region experienced a pick-up in department store sales. Merchants surveyed mentioned the warm weather, renewed consumer confidence, and more emphasis on marketing as factors boosting retailing of summer items. Retailers expect that the improvement in sales will continue through the fall and into the Christmas season.

Car sales continued to strengthen in the District in June and early July, boosting prospects that 1988 sales will be significantly better than expected earlier this year. Renewed incentives offered by domestic manufacturers have contributed to the improved sales experience, and disappointing import sales are intensifying competition across the board. Through May 1988, new vehicle registrations in the Southeast were up 6 percent over the comparable period in 1987, matching the gain in registrations nationally.

Construction Nonresidential construction in the Sixth District remains healthy, increasing by 5 percent through May over the comparable period in 1987. However, residential construction in the Southeast region is down 11 percent for the year and continues to lag behind national levels. Atlanta has seen a surge in office building construction in the northern sector of the city. High-rise office construction in Tampa is booming, spurred by a downtown office vacancy rate that has dropped nearly 10 percentage points in three years. Interestingly, this expansion was fueled by existing downtown tenants, rather than relocations.

Declining values in residential construction in the District have been associated with moderate to strong home sales. Miami and Atlanta report strong existing home sales in June and early July, spurred mainly by consumer expectations of further rises in interest rates. In Louisiana and Mississippi, soft demand coupled with intense scrutiny of loan applications is making business difficult for homebuilders.

Financial Services Overall loan growth in the District edged upward in June, largely as a result of an uptick in the rate of growth of business loans. Contacts in Florida and Georgia attribute the improvement in commercial loan growth to a surge in export sales and the growing emphasis on middle market companies. Bankers in Alabama and Tennessee reported that consumer installment and indirect retail lending were very strong during the quarter just ended, as were residential mortgage and home equity lending. Several commercial mortgage lenders are noticing a definite slowdown in the number of new deals added to their pipeline.

Tourism The number of visitors to the Southeast has increased marginally over last year. However, convention activity should get a boost this summer. The Democratic Convention in Atlanta hosted over 30,000, and New Orleans is expecting 45,000 for the Republican convention. Hotel occupancy in the region is holding steady with the exceptions of Jacksonville which is experiencing a 10 percent drop from last year due to overbuilding, and New Orleans which showed a 5 percent increase in April due to heavy convention activity.

Agriculture, Forestry, and Mining The drought has arrested crop growth and curtailed the expansion of southeastern livestock production. An increasing frequency of showers has been noted across much of the region since early July. Soybeans, cotton, peanuts and grain sorghum can still recover with the resumption of adequate rainfall. However, most of the early corn crop is beyond help. Crops in the southern portion of the region including rice, sugarcane, citrus and vegetables, have received near-normal rainfall and are showing good prospects. Pastures and forage crops are reviving where recent rainfall has occurred and most cattlemen have held on to their herds by supplemental feeding.

Demand has weakened in the forestry industry during the past month and prices have softened. The uptick in interest rates has slowed building activity but the home repair boom and increases in lumber exports to South Korea and Japan have provided some offsetting support for the lumber market. Coal production continues to rise but oil production has slipped 7 percent from the same period last year.

SEVENTH DISTRICT--CHICAGO

Summary. Most reports on business activity in the District indicate continued strength. So far this year, total payroll employment in the five states has trended upward at a somewhat slower pace than in the nation, mainly due to first quarter layoffs at auto makers and suppliers. Production cuts and stronger sales cleared excess car inventories, and were followed by increases in production. Purchasing managers in Chicago reported strong gains in activity through June, with widespread price increases. Reports are similarly robust from contacts in various industries, with the main exception being office and residential construction. Steel demand continues strong, reflecting the rise in auto production, improved markets for a wide range of equipment, and vigorous demand for construction steel reflecting in part rising industrial construction. Severe drought, relieved by scattered rains in mid-July, has caused serious problems for many farmers and adversely affected agricultural suppliers. Production cuts, or the possibility of cuts, resulting from low water supplies have been reported in a few other industries, including papermaking and petroleum refining, but do not appear to be widespread.

Motor Vehicles. Sales of cars have exceeded the expectations of many forecasters. The first half sales rate outpaced sales in all of calendar year 1987, though trailing 1986. Inventories are in good balance. Production is expected to stay relatively strong in the second half. Truck sales have trended upward and are likely to exceed 5 million units, a record, for all of 1988.

Steel. Production of steel is slowing in the third quarter to allow for needed maintenance and to keep output in line with seasonal slowdowns at customers' plants. Robust orders should support a high level of output over

the rest of the year. Sales at steel service centers, which have been growing very strongly, are slowing less than usual at this time of year. Shipments of steel to motor vehicle makers are expected to stay strong. Purchasing by other consumer goods makers is holding up well. Demand from some equipment makers is the strongest since before the 1981-82 recession. Orders for construction steel continue robust, overall, helped by the upturn in factory construction.

Equipment. Manufacturers of various types of equipment are seeing good demand for their products. Some machinery makers report double-digit increases in orders and backlogs, with particularly large increases in sectors which had been depressed. Orders for metal-cutting machine tools this year have been about double the year-earlier pace, though still well short of the high levels of the late 1970s and 1980. The upturn is broad-based and inquiries suggest that further gains in orders are likely. Railcar orders are up sharply after having been very depressed since collapsing in the early 1980s. A lift truck manufacturer is shifting some production from a European plant to Illinois. Makers of other materials handling equipment, food industry machinery, and other types of business equipment have seen sizable gains in orders. Demand is described as very good for various types of fabricated metal parts. Consumer goods sales are holding up well, including appliances as well as other types--buying of boat trailers, for example, is quite strong. However, there are indications that the recent strengthening in agricultural equipment is starting to abate.

Construction. Construction activity in the District this year is at a fairly high level but shows signs of slowing. Contracts for residential construction (measured in square feet) in the first five months were 15 percent

below a year earlier in the five states. The sharpest year-over-year declines occurred early in the year, reflecting adverse weather, but contracts in the spring continued below a year earlier. Pouring of concrete at Chicago-area residential construction sites this summer is reported to be at a good pace but below last spring despite favorable weather. Nonresidential construction contracts in the first five months were 5 percent lower in District states. In contrast, shipments of gypsum board in the District states for five months were 1 percent higher than last year, reflecting finishing work on structures begun earlier. Chicago office building construction, still at a high level, is described as having slowed somewhat, bringing the market for office space into better balance. The industrial real estate market and construction of factories and warehouses have strengthened. Work on highways and streets in the District will be strong this year.

Agriculture. With no respite until recently from extremely dry and hot conditions, prospects for this fall's crops deteriorated sharply. Hot weather throughout much of the Midwest, coinciding with the start of the pollination stage for the corn crop in early July, inflicted irreversible damage. Estimates of the resulting reductions in per acre yields, however, are still subject to considerable uncertainty. Scattered rain and cooler temperatures beginning in mid-July appear to have halted the deterioration in corn condition ratings in much of the District. Soybeans remain under stress but the improved weather will temper the overall decline in production. During June, most of the irreversible damage was concentrated on spring wheat, barley, oats, and hay. In addition, the grazing capacity of range and pasture land was seriously depleted and vegetables in the Great Lakes region, an important source of processing supplies, were hit hard.

EIGHTH DISTRICT - ST. LOUIS

Summary

The District's economic growth has been sluggish. District employment has leveled off in recent months, growing more slowly in all sectors than in the nation. Both consumer spending and construction activity have also been weak. Meanwhile, it appears that the drought will reduce District corn yields by as much as 50 percent, but recent rains will help the soybean crop.

Employment

Following rapid growth earlier in the year, District nonagricultural employment rose at only a 0.4 percent annual rate in the three months through May, while rising at a 3.6 percent rate nationally. District employment growth trailed the national average in all sectors. Employment in District services and trades sectors--major sources of earlier growth--expanded at only a 1.2 percent rate in the March-May period, while in goods-producing sectors, including mining, construction, and manufacturing, it declined at a 2.5 percent rate. Nonelectrical machinery was the only manufacturing sector in which employment grew substantially.

Consumer Spending

District department store sales have been weak in recent months. Retailers in Memphis and St. Louis report second-quarter sales

slightly below year-ago levels, while Louisville and Little Rock sales were flat to 5 percent higher. Sales of shoes and women's apparel were particularly weak. Inventories, however, are only slightly higher than desired because of heavy discounting to liquidate summer goods. The outlook is one of cautious optimism: retailers generally feel that sales in August and September will be 2 to 6 percent higher than a year earlier. In line with these restrained expectations, inventory growth of fall goods should be more limited than in recent years.

Construction

District construction activity declined in recent months and was considerably weaker than the national average. Much of the decline was concentrated in Arkansas and Kentucky. The value of District residential building contracts awarded in the three months through May fell 6.9 percent from the previous three-month period and was 8.9 percent lower than a year earlier. Nonresidential building contracts fell by 12.7 percent in the March-May period and were down 18.6 percent from a year earlier.

Banking

Total loans at weekly reporting District banks increased at a 7.7 percent annual rate in the second quarter, somewhat slower than in the same period last year. Commercial lending, which has picked up in recent months, expanded at a 9.3 percent annual rate in the second quarter, slightly higher than in the same period last year. Much of the acceleration in commercial loan growth, however, can be attributed to purchases of loan participations by large District banks.

Agriculture

Widespread rains arrived too late to prevent significant damage to the District's corn crop. Corn yields are expected to be down 50 percent or more in Missouri, southern Illinois and central Tennessee. Western Tennessee received timely rains in early July; still, corn yield losses of 25 percent are anticipated.

Farmers' have turned their attention now to the soybean crop which accounts for over 30 percent of District crop receipts. Some damage to soybean yields has already occurred but the crucial period of growth--from late July to mid-August--is yet to come. With enough rain during this period, further damage to soybeans can be minimized and a near-normal crop harvested. The drought caused some soybeans to be planted much later than normal, however, increasing the risk that an early frost could damage the crop. Cotton and rice in Arkansas have suffered only minor drought damage, with over 90 percent of these crops in fair-to-good condition.

The Mississippi River remains open to barge traffic, but travel times from St. Louis to the Gulf of Mexico have doubled. So far, the river network has been able to meet export commitments because grain shipping is normally slow at this time of the year.

NINTH DISTRICT--MINNEAPOLIS

General economic conditions have held firm in the Ninth District. Employment demand has remained high, and consumer spending has continued to grow moderately. Recent rains should eventually help some drought-stricken crop, livestock, and dairy operations. And agricultural bank conditions, while not improving, have not yet deteriorated either.

Labor Markets

The most recent statistics indicate that district labor markets have experienced some additional tightening. During May, Minnesota's unemployment rate dropped to 3.2 percent, its lowest level in 9 years. The unemployment rate in its Minneapolis-St. Paul metropolitan area fell to just 2.8 percent. In that area, temporary help agencies report some spot labor shortages and rising wages paid to clerical workers. Both the labor force and total employment reached record highs during May in South Dakota; its unemployment rate was only 3 percent. Also, North Dakota's unemployment rate dropped to 3.7 percent during May, almost one full percentage point below its level a year earlier. During past years, the Upper Peninsula of Michigan has experienced very high unemployment; this has eased in the 12 months ending in May: from 10.6 to 7.7 percent.

Consumer Spending

Retail spending has continued to grow moderately in the district. One chain reports that its department store sales were 7 percent higher this June than last. One chain plans to significantly expand two of its stores in the Minneapolis-St. Paul metro area. A chain with stores throughout the district reports much stronger growth during this period, but a higher market share probably accounts for much of that strength. Neither chain reports any inventory or credit problems.

District sales of motor vehicles have continued to hold up well. One domestic manufacturer reports that its car sales during June rose 17 percent over their level a year earlier. A district manager for a popular domestic line reports that car sales during June were strong at virtually all its dealers. A recent arena sale in Sioux Falls, South Dakota, went quite well. But district truck sales have slowed relative to car sales, perhaps due to drought-induced buying resistance in farm-dependent areas. Still, vehicle inventories haven't risen above normal levels.

Housing activity has held firm. Home sales in the Minneapolis-St. Paul area during May and June were 13 percent ahead of a year earlier. Residential building contracts in Minnesota were up 5 percent during May. But as has been true for some time, housing activity was stagnant in many cities and towns of Montana and North Dakota.

District tourist spending has increased sharply this summer. Despite burning bans at campgrounds, all tourism industry representatives contacted report increased activity. For example, Independence Day weekend business was way above the expectations of industry sources in Michigan's Upper Peninsula. A source in northern Wisconsin says that tourism there has been running 10 percent ahead of last year. And the Black Hills area of South Dakota has also done well.

Agriculture

Rain during July came too late to significantly help some of the district's wheat, barley, and oats crops but has helped its soybean and corn crops. For example, during the third week in July, the Minnesota Commissioner of Agriculture estimated that 80 percent of Minnesota's soybean crop would survive. Soybeans are Minnesota's second-largest cash crop. Its largest crop, corn, is not expected to do so well: only 60 percent may survive.

Crop insurance will help district farmers cover part of the lost output. Compared to last year, federally sponsored multiperil coverage is up 83 percent in South Dakota, 77 percent in North Dakota, 41 percent in Montana, and 31 percent in Minnesota.

More help has come from prices of farm products, which have continued to rise. Mid-July prices of corn and soybeans on the cash markets were over 70 percent higher than a year earlier, while barley and wheat prices were up around 50 percent. These high prices imply lower government deficiency payments to farmers under current law, but some form of disaster relief might be enacted to replace that loss. Furthermore, farmers with stored crops carried over from last year will benefit from sales at these high prices.

Livestock and dairy operations have been significantly hampered by higher feed prices and a shortage of pasture growth. As a result, more stock has been sold than normal, which has lowered its price as much as 20 percent. Recent rains should help stimulate grass growth, though, and slow the sell-off in some parts of the district.

Financial Conditions

The safety and soundness of district banks do not seem to have been hurt by the drought yet. Members of this Bank's Advisory Council on Small Business, Agriculture, and Labor report that banks are still liquid and looking for good lending opportunities. A prominent banker in Sioux Falls, South Dakota, says that most serious farm debt problems won't be noticed until next year. This Bank's latest survey of district agricultural bankers does indicate that many bankers are expecting low farm income and slow repayment of farm debt during the third quarter. Still, the condition of district agricultural banks substantially improved during 1987, which should help them weather the drought.

TENTH DISTRICT - KANSAS CITY

Overview. The economy of the Tenth District continues to show slight improvement. Retailers, including auto dealers, report steady to slightly higher sales. In the manufacturing sector, lead times for some materials are increasing and some firms report problems finding certain kinds of skilled labor. Housing starts, however, remain at or below last year's levels and lower oil prices are expected to reduce drilling activity. Effects of the drought vary widely across the district with some farmers in drought-free areas harvesting normal crops and benefiting from higher crop prices. Neither loan demand nor deposits have changed much at district commercial banks over the past month, while savings inflows to thrift institutions have risen in recent months.

Retail Sales. Retailers generally report sales steady to slightly higher compared with a year earlier, as well as with a few months ago. Most respondents have been trimming their inventories recently, and are generally satisfied with current inventory levels. Retailers generally expect only modest sales increases in the near term, apart from seasonal items.

Automobile Sales. Automobile dealers report that sales are steady to slightly higher over the last month. Adequate financing is available for qualified buyers and for dealer inventory purchases. The sales outlook has generally improved since the first of the year.

Manufacturing. Input prices have risen moderately from a year ago, but increases have tapered off some in recent months. The recent slowing in price increases is expected to continue in the next few months. Materials are generally available, but lead times have risen. Steel inputs have become harder to get. Most respondents have been expanding inventories, but now plan some trimming. Some firms report problems finding enough skilled labor, particularly machinists.

Energy. Recent weakness in oil prices is eroding some of the stability in the district's energy industry. High output from OPEC producers caused domestic crude oil prices to fall below \$15 a barrel in mid-July. While the level of exploration activity remained stable in June, and slightly above a year earlier, the lower oil prices in July and the outlook for continued soft prices are expected to cause some decline in the district rig count.

Housing Activity and Finance. Area homebuilders report that housing starts are at or below last year's levels. Relative to a month ago, however, housing starts have varied across the district depending on local conditions. New home sales are steady to weak. Most respondents expect housing market performance to remain steady or improve slightly. In addition, most respondents report no problems with construction materials availability or delivery times. A lumber wholesaler reports weak sales compared with both a year earlier and three months ago.

Most savings and loan respondents report that savings deposit inflows have risen in recent months, reversing the weakness observed earlier this year. Inflows are expected to increase slightly in the near future. Mortgage demand has been solid, but most respondents expect weaker demand in the fall. Mortgage rates have been stable to slightly higher, and some respondents expect a slight increase in the second half of this year.

Banking. District commercial bankers report steady loan demand over the past month. Consumer loan demand has shown the greatest strength, while demands for other types of loans have, on balance, been stable. Most respondents increased their prime rates by half a percentage point on or shortly after July 14, following a period of steady rates in June and early July. A majority of the respondents expect no further movement of the prime rate in the near future. Consumer loan rates have been relatively stable.

Deposits have changed little at Tenth District commercial banks over the past month. Although small time deposits increased at more than half of the responding institutions, demand deposits were flat to slightly down. Other deposits were generally unchanged.

Agriculture. The effects of this summer's drought vary widely across the district. The winter wheat crop matured before the drought worsened, and its harvest is nearly complete with yields and quality normal to above normal. Plentiful rainfall in some parts of the district--especially Nebraska and western Oklahoma--have provided excellent growing conditions for crops and range conditions for cattle. Farmers in these areas are likely to harvest normal crops and benefit from prices forced higher by the effects of the drought elsewhere.

In those areas most severely affected by the drought, however--especially southeastern Oklahoma, eastern Kansas, and much of Missouri--non-irrigated row crops are under severe stress, irrigation costs are rising, and range and pasture conditions are deteriorating. In some areas, non-irrigated corn yields may be reduced by half or more. Ranchers are providing cattle herds supplemental feedstuffs where pastures have been scorched. Although the drought has not yet forced the large scale liquidation of district cattle herds, net returns to cattle ranchers and feeders are likely to be squeezed by lower cattle prices and sharply higher feed costs.

Effects of the drought on farm borrowers and lenders will vary widely across the district. However, the general improvement in the financial positions of farm borrowers and their lenders during the last two years will likely allow most to withstand this summer's drought.

ELEVENTH DISTRICT--DALLAS

The District economy remains sluggish overall, in contrast to the steady growth it posted during the second half of 1987. Nevertheless, survey respondents are now somewhat more positive about business conditions than they have been in the recent past. Manufacturers' orders continue to grow, although the expansion is slower than during last year. Drilling has slipped lately. Although retail sales are low, merchants are becoming more optimistic. Construction activity has stabilized. Recent rains have abated the District's drought problems somewhat. Deposits at District financial institutions continue to ebb.

Orders to District manufacturers are generally up from earlier this year. Sales growth for some industries is slower than during the second half of 1987, however. Despite the ongoing expansion, upward pressures on wages beyond normal cost-of-living increases were almost uniformly reported as insignificant. The only notable exception was the electronics industry, where orders are expanding and are expected to continue to pick up for the rest of this year. Demand for primary metals has also been rising, and product and input prices are up. Defense contracting activity for some District aircraft-makers has fallen, but these firms say they are continuing to work through previously issued contracts, so that production has not declined. Although sales of oilfield equipment are growing, the rate of increase is much diminished and respondents anticipate little further expansion. Some firms in the District petrochemicals industry are reaching capacity constraints and they say that high demand has resulted in undesirably low inventories. Apparel

producers generally report very modest sales growth. Orders to construction-linked stone, clay and glass manufacturers continue to fall. Food processing firms anticipate further rises in input prices because of the drought and they expect to pass these price increases on to consumers.

District drilling has recently declined. After a period of modest gains from March through May, the District rig count fell in June and again in the first half of July. Nevertheless, respondents generally expect drilling activity to show little significant variation in the near future and they say that drilling plans will not change much unless oil prices remain below \$15 per barrel for an extended period.

Although retailers report sluggish demand, most of those surveyed believe that the bottom has already been reached. Respondents expect growth in the future, particularly in Houston. The patterns of demand for different types of retail merchandise vary greatly. Apparel sales remain weak while demand for home products is strong.

District auto sales have lately been increasing overall, and dealers have begun to express more optimism about future demand than they have in the recent past. In Dallas, sales are unchanged from a year earlier while Houston has recently shown noticeable growth. Dealers say inventories in Dallas are adequate but that Houston inventories are tight.

District construction activity is flattening after a prolonged downturn. In May, a three-month moving average of District construction contract values posted its first increase in twelve months. Both nonresidential and residential contract values have begun to stabilize. Values of residential building permits have also shown little change of late. Office vacancy rates in major District cities remain among the highest in the nation and respondents do not view the recent stability in

construction contract values as foreshadowing any significant upturns in building activity this year.

Income prospects for District agriculture are said to be mixed. Prices received by Texas farmers and ranchers in June averaged 6 percent above a year earlier, but livestock prices dropped 4.3 percent from the previous month. Some cattle-producers have been selling off their breeding herds in response to drought conditions. Movement of cattle from dried-out pastures to feed lots contributed to a record 705,000 placement of Texas cattle on feed in May.. Since then, recent rains have diminished the already-moderate drought in the Eleventh District and have raised cotton production expectations to high levels. The additional moisture was too late for some drought-damaged corn and for some ranchers, however.

Total deposits at District banks continue to show accelerating year-over-year rates of decline. These declines are dominated by significant reductions in large time deposits and MMDAs. Despite dropoffs in these same liability categories at thrifts, overall deposits at thrifts are expanding. Among District banks, particularly high rates of deposit slippage are being posted at the large banks, and these reductions in liabilities are accompanied by falling asset levels. The highest rates of asset declines are taking place in loans and, chiefly, in business loans.

TWELFTH DISTRICT -- SAN FRANCISCO

Summary

The Twelfth District economy continues to expand at a healthy pace. The Business Sentiment survey reveals that expectations are somewhat more modest than in the last report, although most respondents continue to anticipate healthy economic growth. Auto sales are satisfactory, but retail sales growth remains sluggish. Manufacturing activity continues strong, with most respondents reporting inventories close to desired levels. The drought has not affected most western farmers, although profit margins on cattle are being squeezed by higher feed costs and lower beef prices. Demand for most forest products continues strong, but strikes at several Northwest mills are restricting supply. Construction and real estate activity continues mixed, with the coastal states reporting particularly strong demand for single-family homes. Respondents are about evenly divided between those who anticipate steady wage gains during the next year and those who expect wage increases to accelerate. Banks and thrifts report generally healthy activity.

Business Sentiment

Respondents to the Twelfth District Business Sentiment survey continue to expect GNP growth during the next year to be a little lower than 3 percent, with none anticipating a recession during that period. Compared with the previous survey, respondents are slightly less optimistic about economic growth, and somewhat more optimistic about inflation.

Consumer Spending

Auto sales continue at a satisfactory pace in most parts of the Twelfth District. Inventories of most domestic models are at or below desired levels, but some respondents report that slow sales have increased inventories of imported cars to unsustainably high levels.

Growth of retail sales remains sluggish. One retail executive asserts that the sector is improving very slowly from its poor Spring. Another notes continued slow growth, but points out that retailers have been managing expenses and inventories very conservatively, and earnings therefore have held up reasonably well. Most respondents indicate that retail inventories are close to desired levels.

Manufacturing

Overall, manufacturing activity in the West is strong. Commercial aircraft and heavy equipment manufacturers note especially robust activity. Most information about the electronics industry suggests that it is benefiting from a surge in orders and sales, although one manufacturer of electronic components notes some weakening in recent weeks, and at least two sizable plants are slated to close.

Respondents indicate that overall inventory levels are either close to or somewhat below their desired levels. Lean inventories are reported for sectors that are experiencing strong demand, including some electronic components and exported products, as well as minerals, valves, and castings that are in short supply. A few respondents note high inventory levels, but these respondents also point out that some of the inventory accumulation is an attempt to ensure the availability of products for which demand is expected to be strong.

Agriculture and Resource Related Industries

The drought is not expected to cause problems for most western farmers, since most acreage in the West is irrigated and reservoirs hold sufficient supplies for this summer. Cattle ranchers, however, have range land that is providing insufficient nourishment, and feed costs have escalated substantially due to the drought. As a result, many are selling earlier than they otherwise would, to avoid paying the high feed costs. In the glutted marketplace, they are getting lower prices, and most anticipate significantly higher prices in several months as the glut is worked off.

The forest products industries continue to experience strong demand, from both overseas and domestic markets. Pulp and paper activity is particularly strong, and production is running at capacity. Nevertheless, inventories reportedly are low at both the user and manufacturer levels, so several firms plan to expand their production capacity. However, lumber production has been curtailed because of recent strikes at several mills.

Construction and Real Estate

Construction and real estate activity continue mixed in the Twelfth District. In the coastal states, the pace of residential building is healthy, particularly for single-family homes. In the Los Angeles and San Francisco regions, some areas with limited available space are seeing such frenzied home buying activity that home values have increased by as much as 25 percent during the past year. Activity in Idaho has improved modestly during the past few months.

In contrast, construction activity in Utah was so weak during the first five months of 1988 that it will take a remarkable rebound even to reach 1987's poor showing. Arizona is in somewhat better shape than Utah, but activity continues to languish there as well.

Wages and Salaries

Most respondents anticipate wage increases in the 4 to 5 percent range during the next year. Respondents are divided about evenly between those who expect wage and salary increases during the next twelve months to be unchanged from those of the past year, and those who anticipate some acceleration of wage hikes.

Most of those who anticipate steady wage gains argue that increases will be low due to pressures for keeping costs under control, expectations of weakening activity (as for defense contractors), or a trend toward tying individual compensation more closely to performance. Those who anticipate higher wages cite the pressures for wage increases that have resulted from recent high profits (as in timber), general

improvements in economic activity (as in Boise), and difficulty attracting and retaining qualified workers.

While California is not experiencing labor shortages associated with immigration reform, some farmers in Idaho reportedly are paying day laborers substantially more than they did last year. Few respondents note wage increases associated with California's new \$4.25 minimum wage, which went into effect on July 1. These increases occurred in such low-wage sectors as agriculture, restaurants, and hotels.

Financial Sector

Most western banks and thrifts report healthy conditions, reflecting the healthy regional economies in which they operate. Several bankers note particular strength in consumer lending, while a few cite commercial lending as the leading sector. Bankers in Oregon, Washington, and California report stiff competition for quality mortgage applications.