

CONFIDENTIAL (FR)

CURRENT ECONOMIC COMMENT BY DISTRICT

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## SUMMARY\*

Generally good economic conditions prevail across most of the nation, although there is notable uncertainty over economic prospects. Retail sales have been fairly steady overall--consumer durables have been selling somewhat better than nondurables. Agricultural and industrial production has been strong. Construction activity is mixed, with some increases in commercial construction and some decreases in homebuilding. Inventories are lean almost everywhere. Financial markets continue to be tight. But despite fairly positive assessments of current economic conditions, reports from most districts reveal substantial uncertainty regarding future economic developments due in part to the evolving anti-inflation program.

Retail sales have held up in recent weeks throughout most of the nation. Strong consumer demand was reported in Boston, Chicago, St. Louis, Dallas, Minneapolis, and San Francisco. The weakest demand was observed in New York, Philadelphia, and Atlanta. In between, retail sales ranged from slightly above last year to 10 percent above last year in Kansas City.

Chicago was the only district reporting relatively better soft goods sales than hard goods sales. In Richmond, Atlanta, and Minneapolis the reverse was noted. Several districts indicated that auto and light truck sales did not adequately reflect demand, as slow deliveries held actual sales below potential levels.

Auto dealers aren't the only business people with low inventories. Nearly every district notes the lean inventory positions of most retailers. Some soft goods dealers in Boston, Atlanta, and Minneapolis are concerned about inventory creep, but this concern is much less prevalent than satisfaction with

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\*Prepared by the Federal Reserve Bank of Minneapolis.

inventory levels. Reports from manufacturers throughout the U.S. reveal that the overwhelming majority are maintaining very tight inventory positions.

Since inventories are low, strong demand for manufactured goods has been reflected in healthy industrial activity. For instance, Chicago reports that most producers of capital goods continue to report rising shipments, new orders, and backlogs. Only New York characterizes manufacturing activity as flat, while all other districts cite improvements.

Improvements in agricultural production are also widespread. Richmond, Atlanta, Chicago, St. Louis, and Minneapolis all note good agricultural production. And prices are holding up so that crop values are quite impressive. Livestock producers throughout the nation are also reaping the benefits of high prices.

Recent trends in the construction sector are not so clear-cut as they are in agriculture--commercial construction remains strong but homebuilding has weakened. Atlanta, St. Louis, and Minneapolis each report active commercial building. Meanwhile, most districts state that a homebuilding slowdown is imminent or had already begun.

High interest rates are cited most frequently as the reason for the housing slowdown. St. Louis, Minneapolis, and San Francisco remark that usury laws are making mortgage funds particularly scarce in parts of their districts. Regulation Q is also mentioned as having a detrimental impact on the ability of banks and thrifts to attract funds. The newly legalized automatic transfer service at commercial banks was supposed to have relieved some of the negative aspects of Regulation Q, but at least according to Atlanta, Minneapolis, and Dallas consumer interest in the ATS is currently quite limited.

This lack of interest contrasts with the public response to other recent Administration and Federal Reserve policy actions. New York, Atlanta,

and Chicago report skepticism concerning the likelihood that wage-price guidelines would work. Furthermore, each of these banks notes public concern that the guidelines will turn into mandatory controls with the attendant inefficiencies. Reactions to discount rate and reserve requirement increases are mixed. For example, Atlanta finds that some observers are "reassured that something concrete has been done toward alleviating the inflation and exchange rate situations," while a few others feel the actions were "excessive or dangerous."

Uncertainty associated with the evolving anti-inflation program complicates economic forecasting. Districts report widely divergent opinions on the probability of a recession and on the chances that inflation and interest rates will moderate during the coming year. Boston's panel of experts reflects this diversity of opinion; Professor Eckstein argues that the odds now favor a recession in 1979, Professor Houthakker feels the odds are against recession in 1979, and Professor Samuelson suggests that government policy will have a substantial influence on what transpires and that recession is not inevitable. Similarly, opinions on inflation prospects range from less than the guidelines, according to some Philadelphia respondents, to substantially higher, according to some observers in Atlanta and Cleveland.

FIRST DISTRICT - BOSTON

First District respondents report that economic activity continues to be vigorous. Retail sales are healthy. Manufacturers shipments are still increasing. Inventories in manufacturing appear to be under control, although there is some concern about retail inventories. In the financial sector, the effects of higher interest rates are beginning to appear but this does not seem to have discouraged real growth.

Retail sales are fairly strong. Luxury and collectors items are doing particularly well. Retailers report that consumer debt is unusually high for this time of year. There appears to have been a lengthening in the time consumers are taking to pay their bills. The head of a large department store chain notes that, because of exchange rate changes, his stores are no longer buying Japanese goods and have greatly cut back purchases in Europe.

There is some concern that retail inventories may be too high. One respondent reports that, although there has been a general improvement in the retail sector's inventory position since earlier this year, the industry would still be vulnerable if there were a significant weakening in the economy. One reason for this concern about retail inventories is that manufacturers and wholesalers are offering retailers very attractive deals, thereby discouraging further reductions, in order to keep their own inventories down. Respondents generally feel that manufacturing inventories are lean. One director contends that manufacturers have already anticipated an economic slowdown so that if one were to develop no inventory correction would be needed. Supporting this, a large tire manufacturer claims to have made very substantial inventory cuts since spring. A chemical producer who had been increasing inventories to support

rising sales is now reassessing his position in view of the frequency with which forecasters are calling for a recession. A note of caution was sounded by a director who expressed concern that further shifts to LIFO accounting may be distorting published inventory data. However, although First District businessmen are concerned about the possibility of a slowdown, there are no concrete signs of any weakening in demand. Business remains exuberant.

Loan demand continues to increase. In northern New England both consumer and industrial demand is strong: one banker says that he will be forced to allocate credit before the year is out. In southern New England, the head of one large bank reports that the trend for industrial loans is up but less so than in other parts of the country. Higher rates do not appear to be choking off demand, and there has been a substantial increase in requests for credit commitments as potential borrowers seek to avoid being squeezed out in a credit crunch. Several firms report a slowdown in the rate at which accounts receivable are being paid off; it is thought that delaying payment of bills is being used as an alternative to borrowing from the banks. A number of thrift institutions are considering ceasing to offer the six-month certificates because they have become such a high cost source of funds.

Professors Houthakker, Eckstein, and Samuelson were available for comment this month. Although intervention 14 months ago, when urged by our allies, would have been a mistake, the respondents generally agreed that the slide in the dollar had now reached the point that it "could not be allowed to continue" and that "tactically this was a good time for counter-speculation" to "impress on holders of private capital that the Swiss franc and German mark are not a one-way bet." Houthakker, who had been urging greater gold sales, was generally pleased with the package but does not like the idea of

foreign borrowing. Eckstein argued that the jump in interest rates and the strengthened currency arrangements do nothing to solve the basic problem of the dollar, which can only be corrected by a turnaround in our trade position.

Samuelson disputes the view that a recession is inevitable and the earlier it comes the milder it will be. To contrive a recession is "playing with brinkmanship" and is not justified by either demand-pull inflation or the level of the dollar. To honor the President's commitment to support the dollar, it is now appropriate to aim for a somewhat lower real growth target (such as 2 percent).

Houthakker has been impressed by the recent strength of the economy and feels the odds are still against a recession in 1979, although they have increased slightly. Noting the sharp rise in the weekly wholesale price index, he fears inflation next year in the 9 to 10 percent range.

Eckstein feels the odds are now in favor of a recession next year. He is convinced that monetary policy has now tightened to the point where lending for commercial and residential construction has dried up. He urges the System to conduct a survey to verify the anecdotal evidence that the process is now underway.

SECOND DISTRICT - NEW YORK

The expansion in business activity in the Second District apparently slowed in October, judging from recent comments of directors and business leaders. On the national outlook, there is growing concern and anxiety about the stubbornly high rate of inflation and the recent sharp run-up in interest rates. Respondents were uncertain as to how successful the new wage and price guidelines would be in stemming inflation, with a few even reporting some companies raising prices apparently in anticipation of an eventual return to mandatory price controls. At the same time, many view the program designed to shore up the value of the U.S. dollar in the foreign exchange markets as appreciably increasing the chances of a recession next year. Against this national economic outlook, apprehensions have been voiced about the business prospects for the regional economy. On the financial scene, NOW accounts have been introduced in New York so that it is unlikely that many automatic transfer accounts will be offered.

Retail sales turned in a mixed performance in the district. While retail sales were fairly strong in western New York, the autumn buying season in upstate New York fell below the expectations of directors of the Buffalo branch.

As evidence of the mixed signals being emitted by consumers, some major department stores in New York City reported healthy gains, while others registered disappointment at the low level of October sales. The prolonged newspaper strike was blamed by several New York City merchants as contributing to the sluggishness in retail sales, but a few observers interpreted the slowing as evidence of an incipient weakness that may presage a retrenchment by consumers. Nonetheless, merchants are looking forward to the Christmas season, although the traditional seasonal optimism appears to have been dampened by this undercurrent

of trepidation. Auto dealers in the Second District also reported a softening in consumer spending.

Outside of the consumer sector, the mood of business appears to be sober and cautious. A spokesman for an upstate manufacturer, whose comments were echoed by many manufacturers, reported that business was flat and was probably going to stay that way for a while. Another telling indicator is that the capital spending plans of companies in such diverse industries as chemicals, steel, paper, and prefabricated metals show no evidence of strengthening or have been even pared. An increasing number of businesses now seem to regard the prospect of a recession next year as a foregone conclusion. In this connection, the sharp rise in interest rates and the other moves taken to defend the U.S. dollar were judged to have appreciably increased the chances that there will be a recession.

Respondents were generally unenthusiastic about the probable success of the wage and price guidelines in slowing the rate of inflation. It was generally felt that while business management would do its part in holding price increases to the level sought by the president, unions were unlikely to cooperate. Indeed, the Buffalo directors thought that the anti-inflation program was misguided. It was their feeling that the government itself was contributing importantly to the current inflationary environment through a host of ways--e.g., the minimum wage, Social Security taxes, continued high deficit spending, onerous regulatory burdens, etc. At the same time, a number of businessmen indicated that they knew of instances where prices appeared to have been increased in anticipation of mandatory price controls. Still, the overall impression is that there is little, if any, real evidence of such increases, and the practice appears to be far from widespread.

The offering of automatic transfer service is not likely to become very widespread in New York state, according to a recent survey of Second District banks. Most New York banks contacted said they plan to offer NOW accounts instead. The recently enacted banking act authorized federally chartered financial institutions in New York state to offer NOW accounts, and this privilege was recently extended to state chartered institutions by the state banking authorities. Of the 30 New York banks surveyed, only four (two of which were New York City wholesale banks) said they did not plan to offer either ATS or NOW accounts. In contrast, all the New Jersey banks surveyed said they were already offering ATS. Banks with automatic transfer service estimated that about 60 percent of the balances came from demand deposits at the same bank with most of the remaining funds coming from savings deposits, also at the same bank.

THIRD DISTRICT - PHILADELPHIA

Reports from the Third District indicate that the local economy continues to grow but at a slower pace than in the past few months. Businessmen are not generally optimistic about future prospects. In the manufacturing sector, gains are less widespread than they have been recently, and the effects of the growth slowdown have stopped the expansion of industrial employment. For the longer term, manufacturers see little improvement in business conditions. Retail sales are sluggish this month. Merchants' forecasts of Christmas sales this year are mixed, but a slowdown in 1979 is generally expected. Local bankers say business loan demand is soft and foresee no real pickup within the next six months. Further interest rate hikes are forecast.

Manufacturers responding to the November Business Outlook Survey say economic conditions in the industrial sector have improved somewhat since last month. However, gains do not appear to be as widespread as they have been through most of the spring and summer. In terms of specific indicators, survey respondents report little change in the level of new orders in November, while shipments are up significantly. Consequently, inventories have declined in the past several weeks, and no improvement is noted on the employment front.

For the longer term, manufacturers foresee little improvement in business over the next six months. While no pickup in overall business activity is projected between now and May, new orders and shipments are expected to rise. At the same time, however, survey respondents plan to maintain inventories at their current levels. No change in either employment or the length of the average workweek is forecast. Manufacturers report plans to increase capital spending fractionally over the next two quarters.

Price hikes are again reported in the industrial sector in November. Almost 60 percent of the respondents this month report paying higher prices for raw materials while 25 percent say they have raised the prices of the goods they sell. Looking ahead six months, 90 percent of those surveyed expect to be paying more for inputs by May, and nearly 70 percent plan to charge more for their finished products.

Department store sales are sluggish in November, according to local merchants. Retailers report current dollar sales to be only 3 to 4 percent over year-ago levels. Nevertheless, this is slightly better than had been expected for this period. Retail executives had forecast a sharp dropoff in consumer spending by this time, but such a downturn has not materialized.

As for the future, merchants expectations about the Christmas buying season are a mixed bag. While some look for a good season, others point to the strong sales of last year and believe they will be difficult to match. Looking past Christmas to the first half of 1979, retailers generally expect slow sales to be the rule, with the distinct possibility of a "mini-recession."

Concerning the Administration's anti-inflation program, most merchants contacted feel the program will be largely ineffectual, particularly with regard to wage guidelines, but plan to try to cooperate with the program. They feel that price inflation will be somewhat slower next year so that the price guidelines will not be binding.

A Director of this Bank generally agrees with this view. He too feels that prices will not rise by more than the guidelines. His manufacturing firm will try to follow the wage guidelines, but he is not sure that this will be possible.

Local bankers say consumer loan volume remains strong, but that business loan demand is soft. C&I loan volume is reported to be between 3

and 6 percent over November 1977 levels and either "on target" or slightly ahead of plan. A possible cause of the softness could be high interest rates, according to one banker contacted. He claims business borrowers are turning to other sources of funds to avoid double-digit interest rates. Little improvement in loan demand is anticipated over the next six months.

The prime rate at all of the banks contacted is currently 10 3/4 percent and projected to go higher in the near future. Rising interest rates are forecast through the first quarter of 1979. Bankers believe that a peak in the first quarter could mean a prime rate as high as 12 to 12 1/2 percent.

High interest rates appear to continue to have a slight but definite effect on deposit flows at area banks. Net inflows are slow and time and savings deposits are well below anticipated levels at this time.

FOURTH DISTRICT - CLEVELAND

Economists from Fourth District firms who convened at the Bank last week have scaled down their expectations for output and raised their estimates of inflation for this quarter and 1979. Half of the thirty economists expect at least one quarterly decline in real GNP next year. Retailers and producers of consumer goods are cautious over short-term sales prospects. Manufacturing and mining activity is supported by a high level of auto production, better-than-expected steel and coal production, and additional but small real gains in capital spending. Financial officers prefer tax relief as a remedy for the steady erosion in capital stock. The city of Cleveland appears to be approaching default.

Economists at the regularly scheduled meeting on the economic outlook held November 10 have considerably altered their expectations for output and prices from those given at a similar meeting last June. At that time, the group expected real GNP would increase at about a 3.0 percent annual rate this quarter and 2.5 percent in the first half of 1979. The latest set of forecasts, submitted before the November 1 actions to defend the dollar, indicates real GNP would increase at a 2.5 percent annual rate this quarter, followed by a 1.6 percent annual rate of increase in the first half of 1979 and a 2.0 percent annual rate of increase in the second half. The participants expect the inflation rate to increase at about a 7.3 percent rate in the first half of 1979 and 7.0 percent in the second half. Although in the aggregate the group expects the expansion to continue through 1979, seven economists expect a recession, and an additional eight a one quarter drop in real GNP in 1979. Moreover, policy actions taken on November 1 further altered expectations; at least a third of the group now anticipates a recession in 1979.

Retailers and producers of consumer goods remain cautious over near-term sales prospects. Some look for a relatively good Christmas season followed by sluggish sales through the winter months. Retailers, especially major chains, are reported to have large stocks of goods and are holding down placement of orders from producers. Department store officials are said to be buying cautiously, partly because of uncertain prospects and also because of more than ample stocks of goods. An official with a large food chain noted that consumers are paying more attention to specials and private brand merchandise in an effort to maintain a fixed food budget. He noted his chain is selectively expanding inventories as an inflation hedge.

Prospects for the auto industry in 1979 suggest a reduced level of sales and production, according to a group of auto producers and suppliers. Compared with an estimated domestic sales volume of 9.3 million units and 2 million imports this year, they expect domestic sales of about 8.7 million units and 1.8 million imports in 1979. An economist with an auto producer recently trimmed his 1979 forecast of domestic sales to 9.1 million and imports to 1.7 million units. He noted that imports will fall more than domestic sales because import price increases of the past year have not yet been reflected in prices paid by the consumers. He expects that part of that sales loss will result in an overall market loss of 100,000 cars in 1979. Auto suppliers, especially rubber and steel producers, report a continued strong level of orders from the two major auto producers.

Steel economists have become more optimistic over prospects for that industry. Several weeks ago, they anticipated a continued high volume of imports and inventory liquidation that would weaken production this quarter. More recently, price hedging coupled with an expected drop in the volume of imports

this quarter will likely hold production at about the 87 percent capacity rate of the third quarter. However, a strike by steel haulers could curtail shipments.

Coal production has rebounded to the high levels of earlier this year, following a summer slump. A rail strike contributed to a runoff in coal stocks. Inventories of domestic coking coal, at a record low, induced a surge in imports from West Germany which brought charges of dumping. A freight car shortage is encouraging some coal producers to buy their own cars. The industry expects record production in 1979, but the operating rate would still not exceed 90 percent of capacity.

Mixed expectations mark prospects for fixed investment in 1979. Some economists expect real gains to exceed the 2 percent increase suggested in the latest McGraw-Hill survey. One producer pointed out that much of the recent increase in spending has been concentrated in trucks, autos, and communications. Moreover, some industries are expected to show either little gain or some decline in 1979. Heavy-duty truck production and off-highway tractors are estimated to be at or somewhat below 1978 levels, and machine tool orders will likely drop 20-25 percent in 1979, although a large backlog should sustain production. Others anticipate real gains of as much as 5 to 6 percent over 1978. They cite further strength in freight car production, industrial equipment--including gears and conveyor equipment for mining--and in industrial commercial construction.

At a recent financial seminar at this Bank, chief financial officers of Cleveland-area firms acknowledged that capital stock is being depleted because of inadequate provision for replacement cost of assets. Some asserted that competitive market pressures would not permit increases in prices to reflect replacement costs. Some also felt that financial markets would not accept changes in accounting procedures that would attempt to cope with the problem of

inflation accounting. Others remarked that switching to LIFO penalizes income statements and may hinder a continuous upward trend in earnings, an objective of many firms. Several preferred tax relief rather than changes in accounting procedures as a solution.

A growing feeling of a number of observers is that the city of Cleveland can hardly avoid a default in 1978. A top administration official feels that Cleveland needs MAC-type assistance. Since the mayoral recall election last August, Cleveland's political leadership has remained divided on issues that affect the city's solvency. The administration's effort to raise revenues has been hampered by several factors: the city council's refusal to approve a \$50 million bond issue until a detailed financial plan is submitted, the loss of the profitable water division to regional authority, and the reluctance of banks to refinance \$15.5 million in below-investment grade city notes that are due December 15. Some analysts believe that even an eleventh hour rescue would only postpone an inevitable default until the spring of 1979.

FIFTH DISTRICT - RICHMOND

Fifth District manufacturing activity remains firm at this point as new orders and shipments continue to gain over the past month. Responses to our survey also indicate some drawing down of manufacturers' inventories, particularly of finished goods, during October. Manufacturing employment and weekly hours worked continued to rise among our respondent firms. Nonetheless, manufacturers' expectations for the next six months weakened markedly during the latest survey period. Reports on the retail sector are a mixed bag; automobile sales appear to be slowing, if only slightly, while other retail activity remains firm. Credit demand in the district has been strong in recent weeks, with both businesses and consumers borrowing significant amounts. To date there has been no sign of any substantial moderation in credit demand, even though interest rates have increased sharply. Strong demand for farm loans, rising interest rates, and continued liquidity pressures at some banks were reflected in our latest survey of farm credit conditions.

In the manufacturing sector, activity in the Fifth District continued to expand during October. Shipments and new orders both gained over the month, although the gain in new orders was somewhat less widespread than in September. Backlogs of orders and materials inventories were essentially unchanged, while stocks of finished goods continued to run off. Overall, manufacturers' inventories have been brought very nearly into line with desired levels. Current plant and equipment capacity is also at or near desired levels at most respondent firms. Manufacturing employment also made some month-to-month gains, although these gains were not particularly widespread, and weekly hours worked were up slightly. Prices continued to rise broadly as 65 percent of our respondents reported paying higher prices over the past month.

Manufacturers' expectations deteriorated badly during our latest survey period. Half of the manufacturers surveyed now expect the level of business activity nationally to worsen over the next six months, while over one-third expect a decline in activity in their respective market areas. Over half of these respondents expect to maintain current levels of production in their own firms, but even here expectations have weakened over the past month.

No clear picture of current conditions in the retail sector emerges from our various sources of information. Our survey of retailers suggests some minor gains in total sales and in relative sales of big ticket items over the month. Other sources indicate that sales of department stores have turned spotty around the district with weakness in apparel and other textile products and some scattered strength in home furnishings. Automobile sales, although strong, seem to have tapered off in recent weeks, at least in some areas. A survey of district bankers shows October as a strong month for consumer instalment lending, due largely to automobile sales. Instalment lending is described by bankers as strong but not booming. Use of credit cards by consumers continues to be moderately strong.

Most Fifth District directors have detected no significant impact of the recent run-up in interest rates on consumer demand for homes or the rate of homebuilding in their respective areas. More often it is nonavailability of funds, if anything, rather than the interest rates, which is dampening residential construction and/or sales activity in real estate markets. There is some concern, however, that more serious effects on housing will be felt in the near future. This situation may be compounded by what appears to be a growing reluctance on the part of financial institutions to pay market rates on money market certificates.

Business loans have surged ahead over the past several weeks, although a substantial part of this lending appears to be in response to seasonal credit demands. Commodity dealers and retail stores account for a large share of borrowing at large area banks, but public utilities have also been active. While the major source of recent loan demand appears to be middle market firms that are expanding plant facilities, there has also been some pickup in usage of lines of credit by larger companies. Demand for new credit lines may also be increasing somewhat. Agricultural loan repayment rates and the number of renewals and extensions of existing loans continued to be roughly the same as the improved levels of the second quarter. Banks actively seeking new farm loan accounts showed a modest rise in the third quarter, while the fraction of bankers forced to refuse or reduce a farm loan because of a shortage of funds continued at the reduced level of the second quarter.

Estimates through July reveal continued improvement in district cash farm income, with all of the increase coming from livestock marketings. Drought conditions have reduced corn and soybean yields in some areas, but bumper harvests of these crops and other feed grains are still anticipated. The season average price for flue-cured tobacco continues at a record level, some 13 percent above a year earlier, as the end of the 1978 marketing season approaches.

SIXTH DISTRICT - ATLANTA

Events of the past month have created a sharp contrast between expectations and the current business picture. Growth continues strong in nonresidential investment, heavy industry, and agriculture. There's been some weakening of consumer spending and housing markets, but the near-term outlook remains good. At financial institutions, the rapid run-up of borrowing costs was accompanied by a sharp slowdown in deposit inflows, but no significant liquidity problems have surfaced as yet. A lack of confidence in price-restraint measures and the likelihood of further increases in interest rates has convinced many of the region's businessmen that a recession is in store for 1979.

Retail sales were spotty in October and early November. Retailers in many areas reported sales gains that would not cover price increases, with a further softening of nominal sales in the latest two weeks. Unseasonably warm weather has apparently dampened demand for soft goods, particularly apparel. Strong sales of housewares, furniture, and appliances have kept spending growing steadily in other locations. Generally, retail inventories are heavier than desired; retailers have become more apprehensive about post-holiday prospects.

Auto sales reports are mixed as well. There has been considerable grumbling from dealers that low inventories or slow deliveries of popular models have held sales below potential. Buyers continue to favor the larger, higher-priced models, although a few dealers noted resistance to "loaded" cars. Small trucks are in heavy demand and short supply. The used car market is strong; supplies of late models have become inadequate as

higher-mileage, older-model cars account for a growing share of dealers' stocks. Import sales are still lagging.

Housing markets have continued their gradual slowdown. In southern and central Florida, residential construction activity remains near record levels, but mortgage closings and permits are waning. Directors report that lenders have raised mortgage rates and have tightened credit standards in most areas. Sales and construction of commercial properties, particularly office buildings and shopping malls, appear to have accelerated in the past few weeks; contractors are carrying a sizable backlog of industrial projects. Central Florida is experiencing a boom in all types of nonresidential construction, including several huge tourist attractions.

Heavy industries are enjoying very good business. A regional industrial supplier reports sales up 20 percent over the year-earlier level. A railcar manufacturer describes demand as "unbelievable" and claims his current bookings could keep him operating at full capacity for 13 months. Manufacturers of metal products find their sales steady and have been shipping from inventories. U. S. Steel plans to add steel finishing facilities in Birmingham to complement its new blast furnace and coke oven battery. In contrast, the southeastern textile industry, ailing from import competition, sluggish apparel sales, and the demise of denim, continues to pare operations and lay off workers.

Crop harvests, speeded by dry weather and now virtually complete, have been good. Yields are slightly better than average for cotton and soybeans, with total output somewhat below last year's for cotton and sharply higher for soybeans; prices and demand are good. Citrus production has fallen short of expectations, pushing up prices. Drought-damaged winter

grazing pastures have forced many cattlemen to dip into feed supplies and could precipitate additional herd liquidations. Pork production has failed to expand significantly.

Deposit inflows to both banks and thrifts slowed sharply in October. Interest rates climbed, with the prime rate reaching 10-3/4 percent at many large banks. Directors have pointed out that most banks are fairly liquid and in good shape to weather further increases in interest rates. S&Ls have become noticeably less aggressive in raising funds via the costly six-month certificates.

According to branch directors, most major banks began offering some form of ATS on November 1. Set-ups run the gamut from simple overdraft protection to zero-balance demand accounts, with wide variety in pricing structures. Promotions have varied greatly, even within cities; some banks have embarked on a virtual blitz of television, newspaper, billboard, and radio advertising and give-aways, while others have been completely silent. Consumer response has been limited so far.

Southeastern businessmen have become markedly more pessimistic since last report. Although the great majority are pleased with current business conditions, only a handful of contacts consider the probability of recession within the next year remote. The uneasiness has been reflected in increased caution in planning and management of inventories, cash flow, and personnel and closer watchfulness of business indicators. By and large, the business community feels that recent and prospective government actions (or inaction) will be largely responsible for any slowdown.

President Carter's anti-inflation program has not lowered expectations of inflation. Generally, respondents have little confidence that

voluntary controls will work, describing them as a "stop-gap measure" or "the first step toward mandatory controls." Some suspected that either the Government or the unions would not hold up their end of the bargain. Several were troubled that the guidelines permitted larger increases than they were accustomed to in their areas and noted that 7 percent could become a floor, rather than a ceiling, for wage hikes. That possibility and the emphasis that the problem has received of late may have even raised inflationary expectations.

The discount rate and reserve requirement increase and dollar-support announcement seem to have reassured many that something concrete has been done toward alleviating the inflation and exchange rate situations, although few are convinced that it will be enough to solve the basic problems. Only a couple of respondents felt that the interest rate increase was excessive or dangerous, but all expected further rises to take a toll in the year ahead.

SEVENTH DISTRICT - CHICAGO

Economic intelligence available in the Seventh District suggests that the general business expansion will not be halted in the near future either by higher interest rates or accelerating inflation. The President's inflation program outlined October 24 is viewed by most observers as being of minor significance. Some analysts are predicting a recession to start about mid-1979. Demand for capital goods remains strong. Inventories are generally in good shape. Job markets remain vigorous. Retail sales seem to be holding at a high level overall, but results vary by establishment and product. Mortgage credit has tightened further. Housing permits and transactions have declined in major centers. Farmers are prosperous and farmland values have increased further.

Economic forecasts for 1979 vary substantially. Some predict a continuing rise through the year, while others insist that a recession is "inevitable," probably starting around midyear. Some seek refuge in seeing a "50-50 chance" of a recession.

Comment on the President's inflation program has been surprisingly sparse. Executives willing to express themselves in public are laudatory for the most part. They promise "full cooperation," and say "Our company will follow the guidelines to the letter." These views probably reflect the belief that the rules are flexible and will not weigh heavily in decision making. Comments by economists and financial analysts are often more critical with some suggesting that the program, to the extent it is effective, will do more harm than good. Many observers fear that the rules are really mandatory, and will be followed by stricter formulations.

Executives in business and finance complain with some heat of the

rapid growth of controls, despite assurances to the contrary, and the manner of their administration. The anti-inflation program is expected to result in added paperwork and loss of time spent in "educating" federal monitors. The energy bill is judged to be difficult to administer without significantly affecting the supply and demand for energy either for better or worse.

Most producers of capital goods continue to report rising shipments, new orders, and backlogs. Various diversified producers report orders up 20 to 50 percent in September and October, greater gains than were achieved earlier in the year. Demand for farm and construction equipment has continued very strong and above expectations. Orders for castings, forgings, and types of steel used by equipment producers indicate further increases in output of producer goods.

Output of heavy trucks is at record levels, and the largest producer is "supplier limited." Demand for freight cars far exceeds capacity, and some believe no letup will occur in 1979. U. S. plants could produce 95,000 freight cars per year a decade ago, but only 65,000 now. Castings of various types are in great demand, and constitute a major bottleneck. Some producers of castings have activated expansion plans, a step that would not have been seriously considered until recently.

Some analysts believe that orders for both heavy trucks and freight cars are artificially high and that a reckoning lies ahead. Some believe this is true of capital goods generally. Nevertheless, various companies assert that they are controlling their backlogs carefully to keep out "water." Some do not include orders with cancellation clauses; some require stiff penalties in case of cancellations.

Inventories are not excessive and probably will not become so unless

sales drop sharply. Companies insist they are watching the situation carefully. Inventories of farm and construction equipment are judged to be low. Petroleum products inventories are somewhat low, especially gasoline. Leaders of a strike of steel haulers that began last weekend (apparently to sever connections with the Teamsters) believe they will win because user inventories are tight. Even a large retailer whose sales have been running slightly below year ago, in contrast to the industry, says inventories are in line because orders to suppliers had been reduced promptly. Also supporting the view that inventories are lean is the recent stretchout of delivery times. The October report of Milwaukee purchasing managers (a preeminent capital goods town) shows 49 percent with longer lead times, compared with 18 percent a year ago. There has also been a significant rise in the proportion of these managers reporting poorer dependability on deliveries and lower quality.

Despite reduced sales reported by a large chain, total sales of general merchandise have been running 12-13 percent above year ago. Appliance sales have leveled off at about the year-ago level. TV sales have slowed recently. Consumers are spending more on nondurables, gasoline, and air travel. Credit use has remained strong with no rise in delinquencies. Sales of light trucks to consumers have been limited by capacity, especially four-wheel drive models. At least one major auto producer has shifted its production of cars away from larger models with larger engines to help meet mileage standards, regardless of consumer desires.

Home mortgage rates moved up to 10 percent and more in various areas in the past month. The impact of tighter credit is increasingly evident. Permits were down 21 percent in the Chicago area in September and 8 percent for 9 months. In the Milwaukee area permits were off 42 percent in September and 23 percent for 9 months. Transactions are also down.

EIGHTH DISTRICT -- ST. LOUIS

Economic activity in the Eighth District has continued up in recent weeks, although the rate of gain appears to be moderating in most sectors of the economy. A number of positive features were reported including gains in consumer spending, industrial sales, and production in a number of important industries including agriculture. No excessive inventories were reported; however, some moderation in gains was reported in the housing and housing-related industries. Home sales reportedly dropped off somewhat more than seasonally this fall, and appliance sales have also flattened out. In addition, credit for homes may become scarcer as usury laws limit the interest rates that may be charged in some states.

Retailers report that consumers are still in a "buying mood" and that the overall sales trend continues up. Department store representatives are optimistic about Christmas sales and express satisfaction with current inventory levels. Automobile sales are also reported to be at a high level, and further gains are expected for the remainder of this year.

Overall, industrial activity continues to register gains, but slowing was reported in some industries. A slowing in sales was most notable among firms related to the homebuilding industry. Two major appliance manufacturers reported that sales so far this quarter were not as strong as earlier in the year, and one reported production plans for a downturn in sales in the near future. Reasons given were a slowdown in the housing industry and changing consumer attitudes toward credit purchases. A representative of a major chemical firm noted that sales gains have continued, but the rate of increase has slowed somewhat from the rapid

advances of the past few months. A paper industry representative described business as being at a "frantic" pace, but some slowing is expected early next year. A representative of a car assembly plant in the area reported operations are at a very high level, although part of this production is to fill inventory demand created by the new models. An automobile replacement parts manufacturer has experienced excellent sales this year and expects 1979 to be a very good year. Representatives of the steel industry are also optimistic about sales for 1979.

Construction activity, on the whole, remains strong in the District. A representative from Arkansas noted that construction in that state was booming and some material and skilled labor shortages have developed. While current home construction activity is still fairly strong, based on past backlogs, recent home sales are reported to have dropped off somewhat more than is normal for this time of year. Current home mortgage rates in the St. Louis area are in the 9-3/4 to 9-7/8 percent range on 80 percent loans, and at the 10 percent Missouri usury ceiling on 90 percent loans. Loans with small equities have in general become unavailable in states where rates are bumping up against the state usury ceilings.

Loan demand continues to advance at a very rapid rate in recent weeks. Large commercial banks report sizable increases in industrial, consumer, and real estate loans and have raised their prime lending rate in step with the trend in the national loan market. Deposits at commercial banks have also increased rapidly in recent weeks as bidding has been aggressive for both large and small CDs. Inflows at savings and loan associations continue to advance at a moderate pace. The new six-month certificates are reported to be drawing considerable customer interest as

rates paid have risen. Savings and loan officials, however, are concerned over the rising cost of these funds, particularly in areas where usury laws restrict the rate that can be charged on mortgage loans.

Unusually good weather conditions have accelerated this year's harvesting of crops in the District. Production of corn, soybeans, and tobacco exceeds last year's level, but cotton production is down substantially, reflecting decreased plantings and lower yields. Greater production and higher average prices than last year are expected to result in substantially higher farm incomes than a year ago.

NINTH DISTRICT - MINNEAPOLIS

Business is generally good in the Ninth District, but the outlook is clouded by uncertainty regarding the likely impact of government moves to combat inflation. Overall retail sales have been brisk, even though some recent slackening in soft good demand has been reported in a few communities. Area industrial, construction, and agricultural enterprises have been busy. Except for grain farmers, most businesspeople have been keeping a tight rein on inventories. And demand for credit remains strong even as interest rates soar. But despite the general vigor of the district economy few observers are sanguine about the future as the economic ramifications of recently announced wage-price guidelines and financial market actions are difficult to predict.

Retail sales activity is holding up fairly well throughout most of our district. Retailers located in agricultural communities have enjoyed particularly strong sales according to our Bank's quarterly survey of agricultural lenders. Consumer durables have been selling better than nondurables in these areas as well as in the rest of the district. In fact, two Bank directors report that nondurables sales have slackened noticeably in some parts of Minnesota and Michigan's Upper Peninsula.

There has been no slackening in the district's manufacturing sectors. One of our district's largest manufacturers in the nonelectric machinery industry reports production rates are up almost twenty percent from a year ago. While this increase in production is unusually large, other manufacturers are busy too--the most recent figures on total manufacturing employment for our district are up almost five percent over last year.

Construction employment gains have been even more impressive--a nine percent increase during the past year. Our Bank's directors report very tight

construction labor markets throughout most of the district. In a few areas residential construction activity has weakened, but so far vigorous commercial building has made up for that weakness.

Farmers are enjoying good times as well. Eighty percent of the Montana bankers responding to our most recent Ag Credit Survey report their farmer customers are making more money this year than last. Higher livestock prices are cited as the primary reason. Furthermore, grain harvests throughout most of the district have been abundant. And grain prices have held up well, making for record crop values in many parts of the Upper Midwest. Farmers have been storing much of the harvest and reports from around the district indicate grain inventories have nearly exhausted existing storage capacity.

Large inventories are unusual in other sectors of the economy. A survey conducted by a large manufacturing concern headquartered in our region, revealed that eighty-five percent of its business customers placed their current inventory levels in the low to normal range. There was some undesired inventory buildup by the Minnesota retailers faced with slackening soft good demand, but these businesses were the exception to the districtwide rule of low to moderate inventory positions.

With the exception of cement and credit markets, low inventories are not viewed with concern either. Cement shortages have continued to inconvenience some builders. But, as winter moves in, short supplies of cement are becoming less and less of a problem.

In contrast to the cement market, demand has remained strong in the credit market. Bankers throughout the district report that they are having to strain to keep up with loan demand. As elsewhere, nonregulated interest rates are climbing rapidly and the nonprice terms on loans subject to usury limits are becoming more and more restrictive. Furthermore, several of our Bank's directors

voiced concern over the detrimental effects of Regulation Q limits and other regulation on the ability of banks and thrifts to compete with credit unions for funds.

Directors noted that while many banks had begun offering automatic transfer plans, low customer interest suggested the new service would do little to attract funds from other intermediaries. The main plus seen for the automatic transfer plans was that they might usher in pricing for checking services.

Other recent Federal Reserve and Administration policy actions got much more attention than the legalization of automatic transfers. Some observers welcomed the jump in the discount rate and increase in reserve requirements on large CDs as a signal of new resolve in the fight against inflation. Others feared these moves together with the President's wage-price guidelines would harm the real economy.

TENTH DISTRICT—KANSAS CITY

Business activity in the Kansas City District is characterized by rapidly rising prices, satisfactory materials availability, and little improvement in real sales volume. Purchasing agents in the Tenth District report substantial input price increases so far this year and anticipate further increases in the final quarter. With a few exceptions, however, input availability and inventory levels remain satisfactory. District retailers note a recent strengthening of sales, but, in real terms, sales have not improved over last year. Bankers contacted report that loan demand remains strong for most loan categories, especially construction and agriculture. In agriculture, the financial situation is somewhat better than a year ago, due to higher farm prices and improved cash flows.

According to Tenth District purchasing agents, prices for most major inputs are up approximately 8 to 10 per cent over this time last year. For the remainder of the year, input prices are anticipated to increase for metal, clothing, and building materials. Cardboard is expected to increase an additional 5 to 10 per cent. Input material availability does not appear to present a serious problem for most industries contacted. The transportation industry, however, reported an increase in lead times as well as some difficulties in obtaining an adequate number of rail cars and trucks. Also, the container industry reported that lead times for steel-based input products have been increasing and are expected to continue to increase for the remainder of the year. In the building materials industry, insulation and concrete are very difficult to obtain. Currently, material inventory levels are at satisfactory levels for all industries, with the exception

of the metals industry where inventories are too high due to a slack demand from the agricultural sector. As a result, the metals industry will continue trimming its inventories. Most industries contacted expressed no real problem regarding labor shortages. Only firms in the transportation industry and some in the metals industry appear to be near full capacity.

Retailers report that while dollar sales have been improving in the past three months, they are up only about 10 per cent over last year. Mild weather throughout the District was cited as having the effect of delaying sales of winter goods. Other goods that have been weak are home improvement items and major appliances. Clothing, housewares, and domestic goods have been selling well. Retail prices have recently been fairly stable. Most retailers felt that prices may rise about 1 to 2 per cent in the fourth quarter. Inventories have been characterized as "in line with sales" by most stores. Those experiencing somewhat heavy inventories expect them to be corrected by strong Christmas sales. Most retailers, in fact, were optimistic about the Christmas season, though they felt it might be a little slower than last year.

Bankers contacted in the Tenth District report that loan demand remains strong, particularly for agricultural and construction loans. Demands for consumer, real estate, and energy-related loans are also reported as moderate to strong. All bankers contacted raised their prime lending rates recently and expect further increases before the end of the year. As of November 3, most had prime rates of 10 1/2 per cent. Some of the bankers contacted mentioned tightening other lending terms recently or possibly in the near future. Despite these comments, most bankers do not expect to have problems meeting future loan demand. However, some mentioned cutting

back on consumer, real estate, and new loans.

Deposit growth is moderate or down slightly at most banks contacted. Demand deposits are up moderately, but savings deposits are generally flat or down slightly from a year ago due to higher interest rates and shifts to money market CD's. Time deposits are generally flat or up slightly over a year ago. Deposits are expected to grow moderately in the near future due to seasonal factors and a strengthening agricultural sector.

Farm loan demand in the Tenth District has strengthened recently, causing some renewed pressures on bank liquidity. However, due to higher farm prices and significantly improved cash flows, the overall financial picture for the District's agriculture is somewhat brighter than it was a year ago. The upturn in loan demand pushed average loan-deposit ratios at rural banks during the third quarter to levels near the high ratios of a year ago. As of October 1, the average ratio for the District was 63.4 per cent, and ranged from 58 per cent in Oklahoma to 73.8 per cent in Wyoming.

Apparently, farmers are now borrowing to take advantage of profit opportunities. While this development has placed new pressure on bank liquidity, the prospects are good that the farmers will be able to repay their loans as they mature. In the past year, farmers have significantly improved their loan repayment performance. But because of the strains on liquidity, bankers are maintaining collateral requirements, and many continue to refer loans to other credit agencies. Though referral activity does not appear to be increasing very significantly, interest rates on farm loans are rising and now stand about 40 to 45 basis points above year-earlier levels.

ELEVENTH DISTRICT--DALLAS

Business activity continues to advance at a moderate pace in the Eleventh District, according to the Directors and businessmen surveyed this month. Savings and loan association officers are responding to higher short-term interest rates by raising mortgage rates and tightening other mortgage loan requirements. Bankers report a weakening in real estate and consumer loans, but total loan demand continues strong. It appears that the strength of consumer spending is waning slightly, but sales are expected to remain strong through the Christmas season. Manufacturing output has slowed in some industries but overall continues to make moderate gains. Shortages of both skilled and unskilled labor persist.

Pinched by the rising cost of funds, District S&L's require a 20-percent down payment and have raised the mortgage rate to  $9 \frac{7}{8}$  percent. Money market certificates of deposit account for about 40 percent of new savings. So far, S&L's have not diverted significant amounts of funds from mortgages to alternative investments, which are becoming more attractive.

Rising interest rates are changing the composition of loan portfolios at District banks, but the higher rates have not curtailed total loan demand. Real estate and consumer lending are expected to slow further with continued rises in interest rates, but large banks expect commercial lending to national firms will pick up as those firms shift from the commercial paper market to banks. Liquidity remains adequate, although the growth in deposits is slow. Because of its high costs and narrow appeal, automatic transfer of savings is meeting a sluggish response from customers. Banks in general are making minimal efforts to promote ATS.

Many farmers in the District are holding corn and other feedgrains in anticipation of higher prices. Demands for crop storage and farm operating loans, combined with the rising cost of funds, are causing problems for some rural banks in Texas and New Mexico where interest rates on loans to individuals have reached usury ceilings. Several banks are making loans only to their best customers and are referring marginal borrowers to nonbank sources of funds.

Department store sales remain well above a year earlier, but some of the underlying buying strength of earlier months appears to be absent from recent sales figures. Current sales are being aided by sales promotions designed to reduce inventory levels at some stores. The management of one chain store expects a mild recession to occur next spring.

Retail buyers attending a recent market of women's apparel at the Dallas Apparel Mart were cautiously optimistic about sales prospects next year. Because wholesale prices are up sharply from a year ago, buyers were acutely price conscious. Higher quality garments in the middle price ranges sold particularly well. Most retailers indicate inventories remain at manageable levels, although late fall deliveries of woolens pushed stock levels up suddenly at some outlets. Silk and leather are reported to be in short supply.

Auto sales are on par with a year earlier at most dealers. Plymouth and Dodge dealers, however, are reporting 10- to 15-percent declines in sales from a year ago. Some price resistance is noted, but big, fully equipped cars are selling especially well. Inventories of the most popular models are below desired levels at both domestic and foreign car dealers.

Manufacturing activity continues to make moderate gains. Production in the computer and electronics industries continues very strong as these firms report heavy inflows of new orders and rising backlogs. Orders for electric motors are up slightly. Output in the paper and allied products and furniture industries has flagged slightly. Sales of pulp and corrugated boxes have weakened while sales of other paper products remain strong. Furniture dealers appear to have reduced their orders, which is contrary to the increases normally posted this time of year.

Shortages of both skilled and unskilled labor continue to plague many businesses in the Eleventh District. New plants are able to attract needed workers, but existing firms complain of shortages and high labor turnover. One Dallas manufacturer even complains of a shortage of illegal aliens. Because of labor shortages wage rates appear to be rising frequently, especially at the lowest pay scales.

TWELFTH DISTRICT - SAN FRANCISCO

The western economy continues generally strong, though feelings are mixed as to how long this strength will continue given rising interest rates. Retail sales are brisk and retailers are generally optimistic about holiday sales. Despite this optimism, inventories are still under tight control in most areas. While there has not yet been any decline in commercial credit demand due to the rising interest rates, construction activity has begun to weaken in some areas. Basic industrial activity appears still strong, though there does seem to be an unusually large number of strikes in some areas.

In general, retail sales in the West continue strong and most observers expect continued strong sales into the holiday season. Several of our directors argued that the strength in retail sales represented consumers buying now in anticipation of more rapid inflation later. A banker-director felt that currently strong sales in California are being assisted by both rapid employment growth as well as the property tax savings resulting from Proposition 13. Contrary to the consensus, two directors involved in the food industry did not expect especially strong holiday sales.

The general feeling is that despite these optimistic sales expectations, inventories are being kept under tight control, even if this strategy entails some loss of sales. High financing costs are said to be enforcing this tendency to keep a tight rein on inventories. There is one exception to this pattern. The largest department store chain in Oregon, which expects excellent holiday sales, is currently holding inventories equal to sales. It claims that this is an aggressive inventory posture since its normal procedure is to keep inventories below sales.

There are not yet any indications that industrial and commercial demand for credit has weakened due to rising short-term interest rates. The outlook for the near future is extremely mixed with some of our directors certain that the higher rates will not cause a slowdown and others just as certain that the demand for business loans, and thus economic activity, will weaken within the next few months. Most, however, seem to feel that credit demand will weaken somewhat before the second quarter of next year.

There appears to be almost unanimous agreement that housing will suffer from the higher rates. Indeed, weakness in the construction sector has already begun to appear in some areas. The extreme cases are in states with usury ceilings. Idaho, with a 10 percent ceiling, had September housing starts 50.7 percent under a year ago. However, even Utah, which has no interest rate ceiling and has an otherwise booming economy, is starting to see some weakening in construction. In central California, it is reported that building contractors are reluctant to carry any significant inventory of finished lots and are no longer anxious to build houses on speculation.

One exception to this general weakening in construction activity comes from a builder-director in southern California. He claims that construction is still booming and there still exist shortages of labor (skilled and unskilled) and several types of materials (especially cement). He notes that the only slowdown he is aware of is in speculative industrial projects. This same director expressed serious concern about rising construction costs which were generated by two phenomena: (1) a serious decline in productivity and (2) mandated environmental controls.

The aluminum industry continues to experience very strong demand. Kaiser Aluminum plans a 20 percent expansion in capital spending over the next year, but virtually all of this will take place offshore. The market for lumber is generally characterized by strong demand, and American producers are having difficulty supplying the tremendous export demand. Producers do note two trends: (1) the demand for "dimension lumber" is beginning to flatten out which suggests a possible slackening in the housing boom, and (2) particle board demand is down drastically which indicates a slackening in the mobile home industry.

A number of strikes are currently underway on the West Coast. A strike against Safeway continues in San Francisco. Grocery clerks are also striking in parts of Oregon, as are pulp and paper workers and some railroad workers. The total number of workers currently involved in labor disputes in Oregon is the highest it has been since 1970.