

**SUMMARY OF COMMENTARY ON CURRENT ECONOMIC CONDITIONS  
BY FEDERAL RESERVE DISTRICTS**

**March 1989**

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**SUMMARY\***

Economic activity for most of the country is reported to be expanding at a moderately strong pace. Consumer spending, except for autos, has apparently gained momentum while manufacturing, especially for export, continues to show strength almost everywhere. Energy and, to a lesser extent construction, remain the weakest sectors.

In this environment, there is evidence of pressures on costs and prices. Despite additions to productive capacity and improvements in efficiency that are forestalling widespread bottlenecks, materials and product prices are edging up, albeit sporadically and at an uneven pace. Labor markets continue to tighten, with labor shortages noted for both skilled and unskilled workers. Due largely to weather, there are also indications of present and possible future price pressures in agriculture.

Aside from widespread evidence of cost and price pressures, several imbalances are reported. There are signs that excess construction inventories are being perpetuated in some areas. Also while reports of credit problems are isolated, deposit growth is generally weak.

**Consumer Spending**

Most Districts reported strong gains in consumer expenditures for January and February, with the exception of autos. Growing shortages of retail workers as well as other cost and price pressures were noted in a few Districts. Apparel sales, particularly women's clothing, contributed significantly to strength. Some Districts also pointed to brisk purchases of home furnishings and electronics. In contrast, new car sales have slowed and new incentive programs are said to be needed to reduce higher-than-usual inventories. General merchandise inventory levels are typically viewed as lean.

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\*Prepared at the Federal Reserve Bank of Atlanta based on reports received prior to March 8, 1989.

General merchandisers are typically optimistic about spring sales, although Philadelphia expressed concern that an early Easter this year could lower overall sales in advance of the holiday. In a number of Districts, retailers expressed uncertainty about the long range outlook.

### Manufacturing

Most Districts cited some tightness in manufacturing labor markets. Of the Districts that reported on costs and prices, most anticipate increasing pressures due either to current strong conditions or attempts to pass through last year's large increases for particular inputs. In other Districts such as Philadelphia and Boston, more moderate pressures were reported.

Manufacturers generally are optimistic about near-term production prospects, frequently because exports are outpacing growth in domestic demand. Orders for producers durables are strong in the Districts where this industry is relatively important to the economy. Aside from machine tools and the like, transportation equipment sales are also strong. Factory orders for apparel are up strongly in Dallas, and apparel and textiles production is rebounding in Richmond and St. Louis. Production for defense is generally reported as weak except in the St. Louis District, where backlogs are supporting activity. The paper and chemical industries continue to turn in strong performances according to Dallas and Atlanta, although their growth rates have slowed recently.

As far as capital spending is concerned, some of the largest and most broad-based increases are noted by Chicago. However, in the industries where reports were obtained on capital spending, it was generally not expected to exceed last year's strong pace. Often, investment was said to be improving efficiency and modernizing equipment rather than for expanding capacity. While industries in several Districts are said to be operating close to full capacity, there are few comments about serious bottlenecks. In

this regard, Chicago and Richmond note capital spending directed towards reducing bottlenecks. San Francisco reports one of the exceptions--capacity constraints are binding and long delivery times typify production of commercial aircraft and aerospace supplies.

### Construction

Comments characterize housing and real estate activity as ranging from stable growth to weakness. Several of the Districts that reported on this noted high vacancy rates in this area. In construction, multifamily appears weaker than single-family homebuilding almost everywhere.

Nonresidential activity also reflects a heavy inventory condition in several of the Districts that reviewed this. At the same time, building is strong in the St. Louis and Chicago Districts, reflecting industrial expansion in the latter. Chicago also reports very heavy demand for construction steel, whereas in other Districts softening domestic demand for construction materials was seen.

### Resource-Related Industry

Several Districts noted a cautious optimism in resource-related industries. Expectations of higher farm income are fairly widespread and export demand for several products, such as lumber, shows continued strength.

Of the nine Districts that reported on agriculture, four observed concerns that soil moisture problems could threaten crops. The winter wheat crop is already threatened in a number of Districts with the exception of Richmond. The effect of herd reduction during last year's drought has pushed cattle prices higher. Descriptions of the energy industry suggest continued weakness.

### Financial Services

The comments on loan demand suggest little growth, with the exception of Philadelphia. Two Districts reported no trend in delinquencies and San Francisco

indicated credit standards for auto loans were tightening. Some others indicated that concerns were expressed about forthcoming upward adjustments in rates on outstanding ARMs. Atlanta noted that delinquencies, defaults and bankruptcies are on the rise in real estate, with developers in certain overbuilt areas under pressure. Deposit growth was described as weak by all of the Districts that reported on this. Two noted deposit outflows at thrift institutions in recent months.

## FIRST DISTRICT-BOSTON

First District retailers and manufacturers generally experienced good sales growth in January and February. Cost pressures seem to be abating for manufacturers but not for retailers, who continue to find labor markets tight. Nonetheless, merchants remain optimistic because consumer demand seems strong. Most manufacturers are also bullish about their own firm's potential in 1989. Retailers view recent increases in interest rates as a necessary evil; manufacturers feel somewhat immune.

Retail

A sample of First District retailers reports generally healthy sales during January and February. While tracing some of this strength to the mild weather, respondents see underlying vigor in consumer demand. The continuing pickup in women's apparel contributed importantly to the general satisfaction with retail conditions.

Retailers report no major price movements. However, operating expenses are increasing, and retail profits are generally down. With the supply of entry-level labor especially tight, personnel shortages continue and compensation costs are rising. Interest expenses are also climbing, as all retailers contacted are financing significant expansions as well as operating inventories.

Because of rising interest rates, retailers are growing cautious about inventory and other expenditures. However, no respondent has

curtailed or stretched out construction programs. Indeed, respondents report that the optimal size of a retail chain has increased of late. Investments in centralized distribution - the retail version of just-in-time inventory management - apparently allow firms to operate more outlets from a given warehouse, with lower inventory levels, less in-store labor, and greater overall control.

Most retailers see inflation as a cause for concern, especially in the labor market. While expressing anxiety about current interest charges and the extent of credit sales, the respondents thus support recent Federal Reserve anti-inflation policies. They also remain optimistic about 1989 because of continuing strength in consumer demand.

#### Manufacturing

Most First District manufacturing contacts began 1989 with good sales growth. For the majority, sales and orders are running 5 to 15 percent above year-ago levels. Only one firm reports declines in new orders, but two others detect recent signs of slowing. Pockets of weakness involve defense-related products and electronic components. Almost all respondents indicate that exports are "booming."

Unlike the recent past, few manufacturers complained about cost pressures. Most report that input prices are leveling off. In contrast, half of the respondents are raising their own prices (3 to 10 percent) in an effort to increase profit margins. For others, selling prices are stable or down, reflecting falling costs or continued competition in their industries.

On the employment front, all contacts are trying to run lean. The majority report that employment levels are stable or declining slightly.



In contrast to retailers, only two manufacturers complain of tight labor markets. One respondent suggested that the New England labor market has softened recently. Others are trying to avoid this market, for example, by moving high-labor-content jobs to Mexico, or by subcontracting much of their routine manufacturing work. Contacts do not believe that wage pressures are building. Reported wage increases were between 2 and 4 percent.

Among firms discussing capacity, half reported some constraints. Contacts reporting no constraint indicated they could add shifts or lease space if necessary. One observer suggested that new technology has raised manufacturers' preferred capacity utilization rates by a couple of percentage points. Capital spending plans were mixed, with most contacts reporting no dramatic changes from last year's expenditures. Spending plans focused on retooling and maintenance.

Most First District manufacturing contacts have a "bullish" view of 1989. However, firms that depend on military contracts and firms that are targets of hostile takeovers expressed caution. One-third of the respondents project very slow GNP growth in the second half of the year, but they generally expect their own firms to outperform the economy. Most contacts are not distressed about recent interest rate increases. Some firms believe that, because they and their major customers are conservatively capitalized, they may benefit from higher interest earnings and opportunities to make acquisitions from highly leveraged firms. Another respondent suggested that just-in-time inventory systems may have reduced the impact of high interest rates on most manufacturers.

## SECOND DISTRICT--NEW YORK

Recent reports on District developments have tended to be generally on the positive side. Retail sales were mixed during January, but showed some signs of improvement in February. Reports on upstate New York business conditions indicate a strong new orders picture and an optimistic outlook for 1989, but with indications of capacity pressures and rising input prices. Unemployment in the District continues below the national average, though the unemployment rate in New York State did rise on a year-to-year basis in January and employment growth in the District has been slower than in the nation as a whole. The demand for new housing remains generally weak in the District, but a slight increase in buyer interest has been noted recently and office leasing activity has picked up. Following the actions of major banks, small and medium-sized banks raised their prime lending rate a full percentage point in February.

Consumer Spending

District retail sales were mixed during January but respondents reported an improvement in February. The February upturn was primarily centered in home furnishings and men's and women's apparel, with retailers stating that the current fashions finally seem to have caught on. Year-to-year changes in January ranged from -4 percent to +3 percent, results which were below or on plan, while February gains were generally on plan at +4 percent to +8 percent. For one chain February marked the first time sales reached targeted levels in several months.

A survey of major consumer electronics firms in the District found that during the 1988 Christmas season, stores posted strong over-the-year gains of 20 to 30 percent, in sharp contrast to the past two years. Firms are cautiously optimistic about future demand since, at a recent trade show, a number of them commented about a shortage of televisions and VCRs.

Business Activity

Unemployment rates in New York and New Jersey--4.9 percent and 3.9 percent, respectively, in January--remain lower than the national average. However, while the national rate declined by 0.4 percentage point between January 1989 and a year earlier, New York's rate rose by 0.5 percentage point and New Jersey's showed virtually no change. Over this same period, nonfarm employment growth in both New York and New Jersey was only about half as rapid as the national average, due in large part to sizable declines in manufacturing and in New York's banking and brokerage industries.

The percentage of surveyed Buffalo purchasing managers reporting increased new orders rose in January to its highest level since late 1987 while the percentage reporting higher input prices also showed a sharp rise. Elsewhere in western New York, 65 percent of the purchasing managers in Rochester's annual outlook survey anticipate an improvement in general business conditions during 1989 and 83 percent expect their capacity utilization to top 90 percent this year.

Among recent developments in the District, plans were announced to build a new police academy and a large middle-income housing complex in the South Bronx. The complex is to include almost 3000 units in new two-family homes on a 40-acre site now containing dilapidated and burned-out buildings. In the Buffalo area Du Pont will undertake a multimillion-dollar expansion of its plant and Ford Motor will make a major investment in new equipment at its stamping plant. Elsewhere, Crouse-Hinds approved a multimillion-dollar project to modernize its iron and aluminum foundries in Syracuse; and in Connecticut, the Stamford Urban Redevelopment Commission has chosen a builder for a large, mixed-use downtown project. As part of a plan to bring residents and nightlife to the city's center, it will include housing, restaurants, cinemas and medical office space.

Residential Construction and Real Estate

Demand for new homes continues weak in much of the District but a slight increase in buyer interest occurred in the New York metropolitan area, and builders

are somewhat more optimistic about the outlook than they were earlier. With a heavy supply of homes for resale still remaining, more owners reportedly are lowering their prices. Some builders are doing the same while others are providing "extras" and maintaining stable prices. However, builders in western New York and some other upstate areas anticipate good housing demand following last year's strength.

Office leasing activity picked up further in recent weeks and several areas with relatively high vacancy rates report some improvement. Demand from tenants requiring small to mid-sized space was especially strong in midtown Manhattan while some renewed interest from securities and financial services firms was noted downtown. Leasing activity on Long Island and in Fairfield County has also been good and some observers state that the worst of the Fairfield overbuilding is now past. Office vacancy rates in Westchester and northern New Jersey have moved down as a result of virtually no new construction in the former and a slowdown in new undertakings in the latter. However, with almost 7 million square feet of new office space scheduled for completion this year in midtown Manhattan and more than 2 million on Long Island, higher vacancy rates are expected there.

#### Financial Developments

Following the actions of major banks, small and medium-sized banks in the Second District raised their prime lending rate a full percentage point in February--though several bankers stated that they had been surprised at the back-to-back increases by the major banks. Most reported that rates on adjustable rate mortgages tied to the prime reflected the full increase while fixed rate mortgages were up only twenty-five basis points. Despite the higher rates, demand for business loans is steady or growing. Home mortgage loan demand is more sporadic with pockets of slowness. One banker did note that the mortgage market should not be greatly affected unless rates climbed to thirteen percent or more. In the deposits market, sharp increases in rates on certificates of deposit were cited, while rates on money market accounts were unchanged or slightly higher.

## THIRD DISTRICT - PHILADELPHIA

Indications from most sectors of the Third District economy in late February and early March suggest very moderate growth. Manufacturers are posting modest gains, with increases in shipments and orders, while employment is flat and order backlogs are edging down. Retailers say the first two months of the year ran about on plan, as dollar sales rose about 5-10 percent above last year's level. Auto dealers indicate that unit sales are running about even with the year-ago pace. Bankers report fairly steady growth in lending, but note that deposit growth is slipping.

The consensus outlook in the Third District business community is subdued. Manufacturers anticipate only steady activity over the next six months, although this is an improvement from January and February when they were forecasting a downturn. Retailers expect real sales this year to be around even with last year's results, but they say the spring season could be adversely affected by the early Easter. Auto dealers believe they can match last year's unit sales as long as interest rates hold steady or increase only "moderately." Bankers foresee some easing in business loan demand over the next two quarters but they expect both consumer and real estate lending to stay on their growth trends.

MANUFACTURING

Preliminary results of the Business Outlook Survey for March indicate that manufacturing activity in the Third District continues to gain slightly. Twenty-six percent of the survey participants responding in early March said their business was moving up from last month while 12 percent reported slower operations. Specific measures of industrial activity reflect this fractional

growth. Area firms are booking more new orders than they did last month and they are stepping up shipments enough to work down order backlogs a bit. Inventories are level with last month. Employment shows only a little improvement as both payrolls and working hours are moving up just marginally.

Survey respondents continue to report rising prices, although such indications do not appear to be as widespread this month as they have been for the past year. Nearly one-half of the firms polled for the March survey are paying higher prices for purchased goods compared to a month ago and one-quarter are charging more for their own products.

Local manufacturers forecast only steady activity for the next six months, an improvement from the January and February surveys in which expectations of a downturn prevailed. The balance of responses to the most recent poll indicates that managers at area plants expect the rate of both new orders and shipments to be fairly flat for the next two quarters, and they anticipate a further decline in order backlogs. In accordance with these expectations, local firms' employment plans call for steady payrolls and some shortening of the workweek between now and September.

#### RETAIL

Retailers contacted in late February said that sales since the beginning of the year have been about even with plans, and that inventories remain under control. Growth in dollar sales are generally reported to have run 5-10 percent above last year for January and February. Discount merchants have achieved somewhat better results than other retailers, probably due to greater promotional efforts, according to store officials. Most retailers say apparel sales are showing some improvement after the slowdown of the past few years, and several merchants noted renewed consumer demand for hard goods and electronic items.

Retailers say the outlook is problematic. Store officials note that with an early Easter, such as this year's, consumers tend to do less holiday shopping while postponing purchases for warm-weather apparel and other merchandise, thus raising the possibility that sales for the spring season overall could be weak. Consequently, merchants do not expect to be able to get a clear reading on first half results until the spring season is well underway. Looking further ahead, the prospect is still unclear. Several merchants have noted unusually large day-to-day variations in sales in the past two months, and they interpret this as indicating a fragile edge to an apparently high level of consumer confidence. At this time, the most optimistic retailers generally expect real sales in 1989 as a whole to match those of 1988.

Third District automobile dealers report a pickup in sales in late February as manufacturers stepped up incentives in response to some mid-January slowness. Dealers believe that matching last year's rate of unit sales is possible this year as long as consumer income remains strong and interest rates do not rise sharply. Nevertheless, dealers say their profit margins remain under pressure from rising costs and declining gross receipts.

#### FINANCE

Loan volume outstanding at major Third District banks in February was approximately 13 percent above the year-ago level and bankers contacted in early March said this pace of growth was being generally maintained. Some bankers noted a slowing of growth in consumer loans, including home equity credit lines, which they said is at least partially seasonal.

Most of the bankers contacted for this report anticipate an easing in the expansion of commercial and industrial lending as the year progresses. Although they do not foresee a substantial slackening in overall economic activity in the

next two quarters, they do believe credit demand by businesses will ease. Most expect consumer and real estate lending to continue growing at their current rates through the greater part of this year and possibly beyond.

The rate of growth in bank deposits continues on the slowing trend that began last November, according to Third District bankers. Demand deposits have fallen since the start of the year, and bankers say some of that money has been shifted into interest-bearing accounts. In order to maintain asset growth, some bankers say they are more likely to boost deposit rates to gather funds than to borrow in the money markets given the current interest rate differential. However, others believe the recent run-up in rates will be short-lived, and they will accept slower asset growth temporarily in anticipation of lower funding costs later this year.



## FOURTH DISTRICT - CLEVELAND

Developments of recent weeks have not altered the outlook for the economy and for inflation, according to Fourth District respondents. They are optimistic that nonresidential fixed investment will increase more this year than last because of further strengthening in traditional capital goods industries. Retailers, buoyed by much stronger-than-expected spending since last fall, are optimistic over consumer spending at least through the spring. Financial industry respondents do not yet see signs of slower loan growth because of higher interest rates. Thrifts are very competitively pricing CDs, although many experienced another loss of deposits in February.

The Economy. Respondents still expect a slightly slower growth rate in output this year than last, and a slightly higher inflation rate. Even the most optimistic of the forecasters remain confident about their real GNP forecast of slightly more than 3% growth this year. One respondent, however, expects that there are downside risks to his slower growth forecast if interest rates continue to rise, and another believes that higher interest rates make his forecast of no-growth late this year more plausible.

Inflation. Further upward cost/price pressures especially in manufacturing, are expected in 1989 by most respondents. Steel prices are expected to rise further this half before weakening later in the year, and strong demand for heavy-duty trucks, bearings, and special industry machinery is expected to boost prices more in 1989 than in 1988. Many manufacturers are expected to operate at or close to capacity, and will attempt to pass through higher costs of materials incurred last year when conditions may not have been as favorable. Wage rates in retailing are rising because of a shortage of workers. An alternative view of inflation, however, anticipates moderating

inflation because supply will increase faster than demand and energy and food prices will increase less this year than last.

Manufacturing. Capital goods prospects for 1989 are strong, especially for traditional capital goods industries. The bearings industry is still operating at full capacity and may be allocating its output for most of the year. Some industrial equipment producers are also operating at or close to capacity, with orders and backlogs still rising. "Boom" conditions mark the heavy-duty truck business, with operating rates the highest since the late 1970s. A producer of motors and engines reports that the surge in orders last quarter has continued into February and March, although operations are not close to full capacity. Nevertheless, their orders and shipments will be several percent higher than they previously forecast. Strength in most traditional capital goods industries has led one economist to conclude that his forecast of a 6% increase in real nonresidential fixed investment this year could be on the low side. Industry respondents generally do not expect that higher interest rates will dampen capital goods at least this year. They uniformly report that tightness in capacity is being met by productivity improvements and "de-bottlenecking."

Steel producers have been operating at or near capacity, and expect to continue to do so at least through the second quarter. Flat-rolled steel products are still on allocation, although there is excess capacity for steel consumed by the construction and petroleum industries. Lead times are lengthening to as much as 10 weeks because of strong orders that may reflect hedge-buying. Steel respondents expect that a let up in consumption and in inventory buildup in the second half will ease pressures on operating rates and end the allocation of steel now in tight supply.

Consumer Spending. Nonautomotive retailers have been surprised by strong sales since last fall, which they expect to continue at least into the spring months. Inventories, however, will be built only cautiously. A major retailer reported that sales strength continued in February, and he expects March and April sales will show about the same rate of increase. Another retailer is concerned that further increases in interest rates will choke demand because of the link between consumer debt and interest rates.

Auto dealers report February sales were average to a little below average for this time of year and assert that publicity about rising interest rates has begun to affect sales. Many auto dealers are offering special financing plans at below-market rates. Dealers are generally optimistic over spring sales, however, unless interest rates continue to increase.

Financial. Higher interest rates apparently have had little visible effect on borrowing activity. Most lenders believe interest rates on loans have not risen enough to slow loan growth, although some bank economists expect that the latest jump in interest rates, especially mortgage rates, will slow borrowing later this year. According to one economist, the only apparent effect of higher interest rates so far has been in trade rather than in domestic demand; he still expects a 3% real GNP growth rate this year, with a considerably slower second half because of higher interest rates.

Thrift institutions experienced another net deposit outflow in February, although not as severe as in January. Even some large, well-capitalized thrifts had outflows nearly as large or larger than in January. A large thrift reversed its massive January outflow in February, but solely on the basis of its newly introduced CD that is competitive with Treasury bill yields. Another experienced its second successive monthly net inflow of deposits by very aggressive pricing of its CDs.

## FIFTH DISTRICT-RICHMOND

Overview

The District economy generally continued to expand at a moderate pace in February, although retail sales declined. Manufacturing activity, which grew unevenly in January, showed more strength in February. Export activity rose further at District ports while import activity was mixed. Commercial loan demand remained flat in February while the demand for consumer loans was unchanged after posting strong growth in January. The prices of new and existing homes have apparently leveled off, although homebuilding and home sales appear to be normal for this time of year. In the agricultural sector, recent snows and rains raised soil moisture from depleted levels.

Prices at both the producer and retail levels continued to rise at about the same pace as was reported in January. Many manufacturers and retailers indicated that they had increased wages in the last two months. An increased number of manufacturers expressed concern about labor shortages.

Consumer Spending

District retail sales weakened somewhat during February according to our regular mail survey. Almost half of the respondents indicated that sales decreased while about 40 percent reported increases. In contrast, half of the respondents to our January survey had reported increased sales. Most car dealers noted declines in sales in February, but most department store representatives reported increases. A majority of retailers expect sales to increase over the next six months.

A telephone survey of large hotels and resorts in the District indicated that tourist activity this winter was stronger than normal. But District ski resorts, with the exception of those in West Virginia, generally suffered

because of little snowfall and unseasonably warm weather. The District's tourist businesses expect to have a good spring and summer. Almost all resort areas that were surveyed reported that bookings for the months ahead were heavier than usual.

### Manufacturing

District manufacturing activity grew at a moderate pace in February. Half of the responses to our regular mail survey of manufacturers indicated no change in levels of activity. Among the remaining responses, however, increases outnumbered decreases by a ratio of about two to one in all categories--shipments, new orders, backlogs of orders, employment, and the length of the workweek. The proportion of respondents reporting growth in these categories was higher than in our last report. Among manufacturers who export, about a third indicated that new orders from abroad increased since the first of the year; only a few reported declines. Within the manufacturing sector, activity in the textile and apparel industries apparently rebounded from an earlier slump.

District manufacturers remain optimistic about growth prospects in the nation and in their businesses for the next six months. Respondents expecting increases in activity outnumbered those expecting declines in each of the categories (shipments, new orders, etc.) covered by the survey.

### Prices and Wages

Survey responses indicated continued upward pressure on prices and wages. Prices of materials and finished goods apparently rose in February at about the same pace as in January. Twenty-five percent of the manufacturers and 48 percent of the retailers said they had increased wages since December 31, 1988. The average reported increase in wages was 4.5 percent in the manufacturing sector and 5.4 percent in the retail sector. In addition, more

manufacturers than in our January survey expressed concern about labor shortages.

### Ports

Representatives from the three major District ports--Hampton Roads (Norfolk), Charleston, and Baltimore--generally reported continued increases in exports, but their reports on imports were mixed. Export shipments were higher in February than in January at Baltimore and Charleston, while exports at Hampton Roads remained about the same. Although import activity was slightly higher at Hampton Roads and Charleston, it was slightly lower at Baltimore. Port representatives indicated that, compared to a year ago, export activity was outpacing that of imports, and they expect this trend to continue.

### Finance

Our telephone survey of District bankers indicated little change in loan demand. They reported that the demand for commercial loans remained flat in February while the demand for consumer loans stayed at the higher level reached earlier this year. Roughly half of our contacts reported a decline in consumer demand, but no change in commercial demand, for variable rate loans. The bankers reported no unusual rise in the delinquency rates of consumer loans at their institutions.

### Agriculture

Recent snow and rainfall across most parts of the District have reduced farmers' concerns over soil moisture levels. Apple and peach blossom buds in the Carolinas are swelling and opening ahead of schedule but so far have escaped damage from frost. The District wheat crop, due to be harvested this spring, should be large. Acres of wheat planted were 24 percent higher than a year ago, and yields should benefit from the recent moisture.

## SIXTH DISTRICT - ATLANTA

Overview. Business activity, as reported by firms headquartered in the Southeast, continues to move ahead at a moderately healthy pace. Manufacturers and firms in the service sectors report shortages of both skilled and unskilled workers. Compensation gains are said to be somewhat higher than last year at this time. Materials and final product prices are up strongly for particular industries and, in general, appear to be accelerating slightly. Order backlogs, vendor delays and inventories are said to be acceptable relative to sales in most industries. Their capital spending plans show moderate gains over last year's levels. Loan delinquencies at both the consumer and business levels are reported as stable, with the exception of real estate development where pressures are evident. This report incorporates a new panel of business contacts and thus is not strictly comparable to previous ones.

Labor Markets. Wage increases this year so far are generally reported to be in the 3-5 percent range, in line with expectations at the companies surveyed. However, there is some concern that rapidly rising benefits costs will accelerate increases in overall compensation. A majority of contacts reported labor shortages for a wide variety of skilled labor and for unskilled labor in the service sector. At the same time, a significant minority of firms report no problems in hiring.

Prices. Most input and product prices are rising at a faster pace than last year at this time, although price pressures vary widely among the industries surveyed. Prices of many kinds of paper are up 7-10 percent since year end. While demand is strong, contacts are uncertain about whether all of the posted increases will stick. Prices for newsprint are said to be softening due to new industrial capacity and retailer consolidations which are reducing advertising. In chemicals, improved supplies of plastic resins are expected to stabilize prices, which rose by 25 percent in 1988. The price of polyester for textile use is up 20 percent over year-ago levels. Steel used for fabrication in the oil and gas industry is up 7 to 10 percent and computer chip prices are said to be soaring.

Some price softness is occurring in construction and related markets. Except for cement, where imports to the region have declined, building materials prices are soft. Lumber and plywood prices at retail are reported to be up 2 1/2 percent over the last 12 months. Overbuilding has resulted in lower effective lease rates in strip shopping centers, helping to keep chain grocery store costs down; however, the drought's effects have raised food costs.

In agriculture, egg prices have nearly doubled from a year ago and broilers, also up in price, could go even higher this year as the supply of competing red meats is expected to become tighter. Growing international grain and soybean exports are reported to be raising these commodity prices. The price of domestically-produced furniture is up only marginally whereas those on imported merchandise are showing strong gains.

Capacity Utilization. Capacity utilization and order backlogs are reported as strongest for industries where prices are up sharply such as paper and chemicals, and in the heavy equipment area. However, contacts noted only a couple of examples of delivery delays. A few industries that have been experiencing excess capacity, such as the entire energy sector, expect greater domestic production as long as oil and gas prices remain at recently increased levels.

Excess capacity is expected to grow in the construction and building materials industries despite strength in the remodeling segment; slowing public infrastructure investment is said to be a new drag on activity this year. The volume of excess retail trade, office building, and hotel space is growing. While construction of new space has slowed, it is still greater than absorption. Excess capacity typifies portions of the textile and apparel industries where foreign competition is strong.

Investment. Reported capital spending intentions are reflective of current industrial business conditions. Investments in the chemicals and pulp and paper industries are expected to be significant this year, but not to exceed last year's strong levels. In



textiles, acceleration in capital spending is being spurred by international competition, with an emphasis on enhancing efficiency and modernizing equipment rather than expanding capacity. Growth of U.S. exports is boosting railroad freight equipment purchases. Truckers are also expanding capacity by adding equipment and new or expanded terminal facilities.

Credit Situation. Delinquency problems, defaults, and bankruptcies are on the rise in real estate, with a few developers running into severe difficulty. Foreclosures, delinquencies, and restructuring of developers' loans are up this year in Atlanta, Nashville, and in South Florida; on the other hand, delinquency rates on single family mortgages have held steady or dropped moderately. No particular trends were reported at the business or consumer level.

## SEVENTH DISTRICT--CHICAGO

Summary. Economic activity continues to rise in the Seventh District, according to recent reports. Total employment increased in January, partly reflecting unusually mild weather which allowed construction work to proceed at a high rate. Contacts with firms in various industries in the District indicate that sales and production continued to expand in January and February. Car sales have slowed and inventories have built up, leading to limited production cuts. Truck sales have stayed near last year's pace. General merchandise sales in January and February continued to grow. Steel production this year has been above the year-earlier pace, with demand supported by strength in equipment investment and a high level of steel usage in industrial and other construction. Residential building appears likely to slow in 1989. District farmland values continued to recover through the end of 1988. Farm equipment sales in the District fell last year, but a large increase is expected in 1989.

Motor Vehicles. Deliveries of new cars slowed in January and February, following stronger sales in December, and dealer inventories rose. Domestic car manufacturers have enhanced sales incentives. Production schedules remain strong, but output has been pared at some facilities including a Michigan compact car assembly plant. Other plants have slated startups of second shifts. Truck sales in January were highest ever for the month, in contrast with the softness in autos, but sales slipped somewhat in February. Domestic truck production set records in January and probably also in February.

Steel. Output of steel this year is expected to remain at a high level. Raw steel production in the District continued above last year in January and the first half of February, after increasing about 9 percent in 1988. Favorable prospects for steel reflect strength in producers' durable equipment markets and vigorous demand for construction steel, offset by an anticipated mild slowdown in motor vehicles. Exports of steel have risen sharply, from a low base, and imports have

fallen. Raw steel production capacity is expected to increase this year, after seven consecutive years of decline.

Equipment. Near-term capital spending prospects are for continued fairly broad-based increases, particularly for machinery, though the rate of rise in investment is likely to be less rapid than in 1988. Many investment projects started in 1988 will continue in 1989, supporting a high level of spending. Capacity expansion projects in papermaking and other chemical process industries emphasize "debottlenecking." Machine tool orders have risen strongly. Backlogged orders for railcars nearly tripled in the latest year, from a low level. A railcar plant idled for 6 years and a barge builder closed for 3 years are resuming output in District states. Another of numerous Japanese-owned auto components plants was recently announced for Michigan. Competition from these plants is holding down wages at older components producers. A Chicago-area maker of TV picture tubes has increased production and employment in response to shortages. Types of machinery investment expected to show weakness include small earth-moving equipment, reflecting the housing market slowdown. A maker of small gasoline engines recently announced layoffs partly in response to last summer's drought which reduced lawn mower replacement and repair needs. A worldwide shortage of compressors was cited in the planned shutdown of an Indiana refrigerator manufacturing plant.

Construction. Construction slowed in February after unusually mild weather in January boosted activity. Contracts for construction of buildings in District states have not shown the weakness evident over the past 2 to 3 years in national figures. Nonresidential building contracts in 1988, in square feet of floor space, were about even with 1987 in the District states, at the highest level of the current business expansion. Industrial construction is relatively strong in the Midwest, including plants being built to supply new motor vehicle assembly plants of Japanese manufacturers. Industrial building has been strong in northeast Indiana, tied to a new truck plant opened there in 1986. Rental and absorption

rates have been rising for Chicago-area warehouse and distribution space, including industrial buildings in northwest Indiana, which had been depressed. Construction steel backlogs are described as the highest in years, and numerous projects are in the design and engineering phases. However, many firms continue to emphasize equipment investment, making more efficient use of existing space. Just-in-time inventory programs have cut the amount of factory space needed at these plants.

Residential building has slowed, but mainly apartments. Construction of homes remains at a fairly high pace. Residential building contracts in District states last year were 4 percent below 1987, when they reached a high for the 1980s. Mortgage interest rates have risen, with quotes on Chicago-area thirty-year fixed-rate loans averaging 10.7 percent in the latest week and initial rates on adjustables averaging 8.6 percent. Higher interest rates are expected to dampen residential construction activity in 1989.

Retailing. A sample of general merchandise retailers in the Chicago area reported same-store sales in February ranging from about even with a year ago to double-digit gains. Illinois retailers noted a 5 percent increase in sales during the fiscal year just ended, with larger year-to-year gains during the holiday season. A large retailer expects nondurable goods sales to pick up during the rest of 1989. The share of purchases on credit has been trending upward.

Agriculture. District farmland values, on average, rose about 3 percent in the fourth quarter and nearly 12 percent during all of 1988, the second consecutive year of firming following a precipitous, five-year decline. Land values are up about a fifth from the 1986 low but still a third below the 1981 peak.

Unit retail sales of farm tractors and combines in District states fell 4 percent last year, the ninth consecutive annual decline. Nationwide, tractor and combine sales rose nearly 5 percent, despite a marked drought-related slowdown in the second half. Initial reports show January sales below a year ago. However, analysts expect a sizable rise (10 to 20 percent) in sales for all of 1989.

## EIGHTH DISTRICT - ST. LOUIS

Summary

The Eighth District economy expanded moderately in recent months, following several quarters of stagnation. Unemployment rates in most District states edged downward. Employment gains in the services and construction sectors were particularly strong. District banks report improved profitability and asset quality in 1988.

Outlook

A January 1989 survey of 255 District small businesses revealed a slightly more favorable outlook than a year earlier. In both surveys, most respondents felt that general economic conditions would not change substantially in the following two quarters, but far fewer respondents in the most recent survey foresee a general economic weakening. More respondents plan to increase their workforces than in January 1988 (24 percent vs. 12 percent), but there was no change in the percentage planning major capital expenditures in the near future (41 percent). Both surveys found that slightly more than 25 percent of the businesses had job openings they were unable to fill. One quarter planned increases in average compensation to workers in the near future, a slightly smaller fraction than a year earlier.

Responses from the 42 manufacturers in the sample revealed that 48 percent plan to hire workers in the first quarter of 1989, double the percentage for the entire sample. The manufacturers were also having more difficulty filling current job openings (38 percent vs. 26 percent

overall) and were more likely planning to increase compensation to workers (33 percent vs. 25 percent overall).

#### Employment

Payroll employment rose at a 3.4 percent rate in the fourth quarter, following two quarters of stagnation. Strong job growth in services (particularly business and health services), construction and trades was largely responsible for the employment turnaround. Although employment in the District transportation and public utilities sector trended downward in recent quarters, it has continued to grow in Memphis, where the expansion of three trucking firms has caused a shortage of qualified truck drivers. These firms plan to hire 1,500 drivers.

#### Manufacturing

Manufacturing employment rose 2.2 percent in the fourth quarter. Employment in the printing and publishing and the food products sectors rose most rapidly. Producers of transportation equipment continued to increase their workforces. Because of a substantial backlog of orders and the development of new products, the production of military aircraft remains strong in Missouri despite an 8.2 percent drop in the state's defense contracts in the last fiscal year. After falling in the previous three quarters, apparel and textile employment has stabilized because of recent increases in denim orders and gradual declines in textile inventories. Several District lumber mills are expanding this year, in response to sharply increased exports.

#### Construction

District construction activity has picked up in recent months. In the three months through January, the value of residential and nonresidential contracts rose 4.1 percent and 27 percent. The rise in nonresidential building was partially due to large construction contracts

for manufacturing plants in Arkansas, office and medical buildings in Missouri and various buildings in Kentucky. District lumber associations note a slight softening in demand for residential lumber in recent months.

#### Agriculture

District extension agents report farmer participation in government programs is down from last year, indicating that farmers are more confident about profitability in 1989. Favorable weather patterns have brought soil moisture to near normal levels in most of the District. Some portions of the District, however, are still experiencing drought conditions, while others are facing excessive moisture problems. Continuing drought conditions, in conjunction with frigid temperatures in northeastern Missouri, may have damaged the dormant winter wheat crop. February flooding in portions of Kentucky and Tennessee has destroyed a small amount of the wheat crop, and continued wetness has prevented farmers from applying fertilizers and herbicides.

#### Banking

Preliminary data for year-end 1988 indicate that both profitability and asset quality improved at Eighth District banks. Return on assets averaged 0.93 percent in 1988, up from 0.80 percent in 1987. Nonperforming loans dropped sharply in 1988, from an average of 2.10 percent of total loans in 1987 to 1.61 percent. Net loan losses as a percent of total loans remained virtually flat in 1988 as the reduction in net loan losses by smaller banks was offset by increases incurred by banks with assets over \$1 billion.

## NINTH DISTRICT--MINNEAPOLIS

Ninth District economic conditions have continued to be fairly good. Unemployment rates have risen modestly, mostly due to seasonal changes. Consumer spending has been good. Prices have increased moderately and conditions in resource-related industries have been excellent.

Labor Markets

The employment situation has been fairly good throughout the district. Between December 1988 and January 1989, the unemployment rate in Minnesota rose to 5.1 percent from 4.1 percent. An analyst, calling this increase a normal seasonal shift, notes that since 1980 the December to January increase has averaged 1.1 percentage points. The unemployment rate in Minnesota in January 1988 was 4.9 percent. The unemployment rate in the Minneapolis-St. Paul metropolitan area dropped to 3.7 percent in December from 4.0 percent in November. A director notes increasing tightness in the Minnesota labor market, particularly in the retail sector. North Dakota's unemployment rate was 5.6 percent in December, up from 5.3 percent in November and 5.0 percent in December 1987. The unemployment rate in South Dakota rose to 4.6 percent in December from 4.3 percent in November, but was lower than the rate of 4.8 percent in December 1987. Montana's unemployment rate in November was 6.0 percent, up from 5.0 percent in October. The unemployment rate in Michigan's Upper Peninsula was 8.7 percent in November, up from 6.7 percent in October, but lower than the 9.6 percent rate in November 1987.

Consumer Spending

Consumer spending on general merchandise has been fairly strong. One large retailer reports that February sales were up 11 percent from a year ago; and same-store sales, a measure of sales in stores open a year or more,



were up 4.7 percent from February 1988. Another retailer reports that February sales were lower than expected with an 8.5 percent increase in sales over a year ago. Businesses in St. Cloud, Minnesota are very optimistic with approximately \$40 million in bids for new construction expected to be made in the next two weeks. Much of this construction is for schools, which is considered a good sign of population growth. Inventories are at generally acceptable levels throughout the district.

Motor vehicles have been selling well. Dealers for one domestic manufacturer report that sales in the first twenty days of February were down 6 percent from the comparable period in January, but were up 10 percent over the same period in February 1988. Sales were good in January for this manufacturer with car sales up 14 percent and truck sales up 15 percent from January 1988. March is normally the biggest selling month for motor vehicles, so the next thirty days should set the tone for the next year. There is some uncertainty about the effect of recent interest rate increases on motor vehicle sales.

Housing activity has been fairly stable. The number of new housing permits issued in Minnesota increased by 4.4 percent from December 1987 to December 1988. Home sales in the Minneapolis-St. Paul metropolitan area were up 6.24 percent in January 1989 from January 1988.

Tourist spending has been good throughout the district. Heavy snowfall in the resort areas attracted a large number of skiers.

### Prices

Prices have generally been rising. The consumer price index for the Minneapolis-St. Paul metropolitan area rose by 4.9 percent from December 1987 to December 1988. Elsewhere, reports are mixed with one observer reporting remarkable price stability in manufacturing durables, while also reporting

sharp price increases for new lines of farm equipment. One southern Minnesota farmer estimates sharp increases in production costs for the upcoming year, ranging from 9 percent for grain used as cattle feed, to 14 percent for soybeans. A large wholesaler for grocery stores reports that inflation rates for food products are currently averaging around 4.6 percent.

#### Resource-Related Industries

Conditions have been excellent in resource-related industries. The generally good snow cover in the district has restored cautious optimism in most agricultural areas. However, last year's drought continues to raise concerns about soil moisture adequacy in the spring. Economic conditions in the lumber industry were excellent. By one estimate, the pulp and paper industry has committed to \$1 billion worth of capital investment in Minnesota over the last couple of years, and a similar amount is on the drawing boards. A large number of new lumber mills are being built and planned in the Upper Peninsula of Michigan. The capital investments for these mills range from \$38 million to \$300 million. Foreign markets are becoming particularly important for the lumber industry, with 20 percent of the output of one producer going overseas. Conditions in mining have also been excellent. A foreign-owned company is expected to take over an employee-owned smelting company located in Michigan's Upper Peninsula. The employees are expected to receive about \$60 million for their shares of the firm.

## TENTH DISTRICT - KANSAS CITY

Overview. Slow growth continues in the Tenth District economy. Although retail sales are improving, new car sales are mixed. Manufacturers report significantly higher input prices and strains on capacity. District farmers and ranchers are generally in relatively good financial condition after strong income growth last year. Housing activity is little changed from a year ago, however, and home mortgage demand is steady to lower as rates trend higher. Uncertainty about world oil production and prices continues to restrict improvement in the energy sector. Loan demand at commercial banks remains relatively stable, while deposit growth is somewhat weaker.

Retail Sales. Most respondents report current-dollar sales slightly ahead of a year ago, and all respondents report improving sales over the last three months. Promotional activity, in general, is at a normal level. Prices have been relatively steady. All respondents are satisfied with their inventories, which for the most part remain lean. Retailers expect sales to hold at current levels.

Automobile Sales. Sales results have been mixed, with some respondents reporting increases over the past month and others reporting decreases. Adequate dealer and customer financing is generally available. Most dealers report satisfactory inventory levels, although some desire a slight inventory reduction. In general, dealers expect 1989 sales to be near 1988 levels.

Manufacturing. Most respondents indicate input prices are up relative to a year ago and are significantly higher than three months ago. Price increases are expected to continue the rest of the year. Despite some increases in lead times, firms report few difficulties getting materials and do not anticipate future problems. Inventory levels are generally satisfactory, though some firms plan increases. Plants are operating close to full capacity, but no bottlenecks or labor shortages are reported.

Energy. Despite the firming of oil prices since the beginning of the year, the district's energy industry shows few signs of improvement. Uncertainty about OPEC's resolve to rein in production has held down drilling activity in the region and nationwide. The average number of active drilling rigs in the district fell from 246 in January to 219 in February, a fifth below the average of one year ago.

Housing Activity and Finance. District housing activity is generally unchanged from a year ago. Most homebuilders report housing starts were stronger in January than in December, in large part due to good weather conditions. Single-family construction continues to be much stronger than multi-family construction. New home sales and prices generally have been steady. Most respondents expect steady or improved housing activity in the coming months.

Most respondents from district savings and loan institutions report a net outflow of savings deposits over the last month. In almost all cases, net deposit flows were less favorable than a year ago but either unchanged or improved from January. Most respondents expect net outflows of deposits to continue over the near term. Almost all respondents noted adverse reactions of depositors to the recent publicity regarding the savings and loan industry. Mortgage demand is steady to lower. Nearly all respondents report mortgage rates are trending higher. Respondents expect rates to be steady to slightly higher in the coming months.

Banking. The majority of district banks surveyed report little change in loan demand over the past month. Commercial real estate loans were down slightly, while consumer real estate loans increased. Responses regarding consumer loans and commercial and industrial loans were mixed. As the survey was taken, virtually all banks were in the process of making their second 50

basis point increase in their prime rate within a month. Deposits at district banks were constant to down slightly over the past month. All categories of transaction accounts showed weakness, and remaining deposit categories were essentially unchanged.

Agriculture. Most district farmers and ranchers withstood last year's drought and entered 1989 in relatively solid financial condition. Farmland values continued a steady rise toward yearend and are now 16 percent above the lows recorded in late 1986. Results of spring credit reviews by district agricultural bankers reflect generally high farm incomes in 1988. Strong incomes have allowed district farmers and ranchers to pay down debt and replace worn farm machinery. Bankers throughout the district report agricultural loan demand is generally stronger this spring than in recent years. The greater financing requirements of a larger planted acreage and smaller advance deficiency payments are contributing to increased demand for operating credit.

Much of the district's winter wheat crop is under weather-related stress. Warm early winter temperatures and a lack of snow cover left the crop vulnerable to subsequent cold weather, but the extent of damage is not yet known. Some areas of the district have recently received beneficial rains, but subsoil moisture reserves remain below normal. Additional rainfall is needed to ensure development of the crop through the remainder of the growing season.

Despite continued high cattle prices, little expansion has occurred in district cattle herds. Operators are generally maintaining herds at current levels. Inadequate wheat pasture in some areas of the district and high feed prices have discouraged ranchers from enlarging herds.

## ELEVENTH DISTRICT--DALLAS

The District economy is expanding slowly. Growth rates in the strongest sectors have been slowing somewhat, while some of the weaker sectors are strengthening. The overall pace of expansion appears to have changed very little. Manufacturing growth continues, but at a milder rate than late last year. Retail sales are accelerating, while auto sales are climbing at a steadier and more modest pace. After a protracted period of decline, construction activity has lately remained level. Oil and gas drilling activity is unchanged at low levels, in the wake of a falloff that commenced last year. Recent increases in beef prices have raised profits in the District's important cattle industry, but low soil moisture is an ongoing concern for both farmers and ranchers in much of the region.

District manufacturing continues to expand overall, but growth in orders appears to have slowed recently. Several firms said they had managed to keep growing by seeking out new geographic markets. The only serious weaknesses in manufacturing have been in energy extraction-related and construction-related manufacturing. Oilfield equipment sales have declined absolutely in recent months. Orders to construction-related manufacturers - including lumber and wood and stone, clay and glass producers - are weak in most of the District, but some Houston-area producers cite growth. Reports by electronics manufacturers vary a good deal, but sales have generally expanded somewhat in 1989, following a sluggish fourth quarter. Personal computer orders are said to be expanding strongly. Primary and fabricated metals industries continue to show some expansion, but last year's rapid growth in fabricated metals appears to have

slowed. Demand for paper is still strong compared to a year earlier, but some recent slippage in export markets has been cited. In the chemical industry, sales remain well above a year ago, but rates of increase have slowed. A number of chemical plant expansions are underway but, currently, capacity constraints remain a problem for some producers. Apparel industry orders are said to have increased markedly in 1989, and producers say they have been automating in order to compete against foreign firms.

Retail sales growth varies considerably among regions but, on average, it is accelerating. Sales in Austin, Houston, Dallas/Ft. Worth, San Antonio, and on the Mexican border are all expanding at an increased rate, after adjustment for seasonality. Sales in west Texas, however, are weak and show little evidence of growth. Much of the overall acceleration is in apparel sales. Retailers are optimistic about prospects for further growth in revenues in 1989. A number of respondents have lately expressed concern about proposed changes in rules covering workers' compensation, minimum wage, and employee benefits.

District auto sales have lately been mixed, but modest overall, with strong year-over-year January gains in Houston offsetting declines in Dallas/Ft. Worth. Cold February weather was said to have led to more widespread sales weakness in that month.

District construction contracting activity is weak, but it has lately remained essentially level. In 1988, a midyear surge subsequently reversed course, and dollar values of contract issuance remain below a year earlier. Construction employment is still slipping, in response to past reductions in contracting. Recent declines in nonresidential building and nonbuilding construction have been largely offset by growth in residential activity, which

is now above year-earlier levels. The upturn in residential building is chiefly due to single-family home construction. Multifamily residential construction has changed little and remains at very low levels.

After a protracted period of decline, District oil and gas drilling activity has begun to level off. The rotary rig count remains near its lowest level of the decade, but the large monthly declines that characterized the second half of 1988 have at least temporarily ceased. The leading indicators of drilling, including well permits issued and the seismic crew count, also appear to be stabilizing. According to some respondents, the recent leveling off of drilling activity is a result of persistent relative strength in oil prices. This strength has caused drillers to revise expectations about future oil prices. West Texas Intermediate oil prices have remained above \$16 per barrel for each of the last three months, after averaging under \$16 in every month from July through November. A seasonal decline of about \$1 per barrel is expected this summer, but it is not anticipated to change drilling activity.

Despite recent rains in some areas, the chief current concern in District agriculture is continued low soil moisture. Although dryness is still said to be a problem in south Texas, February rains improved soil conditions there. In the Texas panhandle, however, drought conditions have been worsening and the winter wheat crop has already been damaged as a result of scarce rainfall. On average, both crop and livestock prices received by Texas farmers remain well above a year earlier, and prices of both crops and livestock rose in January over December's levels. The overall increase was 1.9 percent, compared to a 1.5 percent increase for the nation.



## TWELFTH DISTRICT -- SAN FRANCISCO

Summary

Business contacts in the Twelfth Federal Reserve District indicate that economic conditions continue to be healthy, with little evidence to suggest that the overall pace of growth is slowing. Expectations regarding GNP growth rebounded in March, with only a third of respondents now expecting weaker growth during the next twelve months. Consumer spending on soft goods has improved in recent weeks, although car sales have been sluggish. Manufacturing activity continues healthy in most manufacturing sectors, with commercial aircraft particularly strong and mixed news coming from electronics and defense firms. Resource industries are stable, but limited log supplies are constraining growth in the forest products industries. Cold and dry weather has generated concern among farmers. Most of the District enjoys healthy construction and real estate conditions, although reports from local observers suggest that the rate of growth may be slowing. Earnings of Twelfth District banks rose to record levels in 1988, but some bankers are concerned that narrowing interest margins and lackluster loan demand may cut into 1989 profits.

Business Sentiment

Respondents' expectations regarding GNP growth rebounded in March. Only 32 percent anticipate weakening during the next year, down from 70 percent in January. Expectations regarding business investment are unchanged, while the prospects for housing and consumer spending seem to have improved. Respondents are less optimistic about improvements in the trade deficit, however.

Consumer Spending

Department store sales have improved, primarily due to gains in women's fashions. Sales currently are running 5 to 6 percent above year-ago levels. Reports suggest that higher interest

rates have had little noticeable effect on buying activity. In Arizona, one consumer confidence index rose 9.3 percent between October 1988 and January 1989.

In contrast, car sales have slowed. Dealer inventories are building, so dealers are being very cautious about additional ordering. Higher interest rates are not now the determining factor for car sales, but tighter credit requirements are hurting volumes. As a result, one dealer reports that 30 percent of his potential buyers were turned down for their loans -- the highest turndown rate in 3 years.

### Manufacturing

Activity remains healthy in most manufacturing sectors. Capacity limits are binding for many aerospace suppliers and major commercial aircraft companies. Concern is rising that both Boeing and McDonnell Douglas could lose business to Airbus Industrie because delivery times are now so long. McDonnell Douglas is considering building new plant capacity, and reportedly is looking outside of Southern California because of the high cost of doing business there.

Reports are mixed for electronics and defense firms. Some respondents note strong electronics and high-tech activity, while others note recent weakening, particularly in semiconductor orders.

Business continues relatively strong in the paint and coatings industry, with some key raw materials in short supply and escalating in price. For several years, paint and coatings manufacturers have held the line on price increases, despite higher costs, but prices are expected to rise soon.

### Agriculture and Resource Related Industries

Although agricultural market conditions currently are good, weather poses a threat to many western agricultural producers. Freezes have hurt the citrus and strawberry crops, although it is

still too early to assess total damage. Continued dry weather through much of the winter has heightened concerns about water availability this summer. Unless March rains are much more plentiful than normal, California farmers will suffer cutbacks in water allocations of as much as 60 percent.

As of early February, lumber and wood products orders were running about 7 percent behind last year's level. 1988 production in the coast region was about 10 percent below its 1987 level, and the industry faces supply problems for 1989. Log prices are reported to be up as much as 33 percent, as high log exports stimulate demand while Forest Service policies constrain log supplies. Because of problems obtaining logs, 33 lumber mills on the West Coast have closed down during the past six months.

Several reports indicate that paper has become more expensive and more difficult to obtain in sufficient quantity. Prices rose about 5 percent for bond paper and 3 percent for newsprint on January 1.

#### Construction and Real Estate

Construction and real estate activity remain healthy in coastal states. Several respondents note slowing real estate and construction activity, although there is disagreement regarding whether recent increases in interest rates have played a role. Some note that the volume of sales has increased recently, and attribute this rise to the fear of further rate increases.

Office building in downtown Los Angeles continues strong, buoyed by foreign investment. Some are concerned that if current plans are carried out, over-capacity could be a serious problem by 1992.

Financial Sector

Most bankers and thrift executives report that loan demand remains relatively weak. Loan volume has been flat for about six months. Few attribute the weak demand to higher interest rates, focussing instead on the continued small pool of quality borrowers. One banker notes that inquiries and fundings on home equity lines are unchanged. In contrast, others argue that higher rates have affected loan demand, making some customers more cautious about borrowing and causing others to borrow before rates increase further. Large banks in Oregon and Washington report that total loans and leases have been rising slightly faster in recent weeks, with accelerating growth in secured real estate loans and weakening growth in unsecured credit.

Some bankers report that deposit growth is strong, but others report that the recent rise in interest rates has hurt balances in passbook savings and market interest accounts. Earnings at District commercial banks were up strongly in 1988, following a loss in 1987. Among District commercial banks, return on equity was 15 percent and return on assets was 0.9 percent, both higher than national averages. However, some bankers have expressed concern that a narrowing gap between borrowing and lending rates may be squeezing profits. But one banker notes that the large proportion of adjustable-rate loans should mitigate the problem to some extent.

The financial services industry in Arizona continues to show the effects of the downturn in construction. Results for financial institutions are mixed, with some institutions reporting significantly improved earnings over 1987, while others recently have made additional provisions for reserves.