SUMMARY OF COMMENTARY ON CURRENT ECONOMIC CONDITIONS

BY FEDERAL RESERVE DISTRICT

June 1989

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SUMMARY*

Economic activity for most of the nation continues to advance, but a number of Federal Reserve districts note ebbing rates of expansion. Although auto sales have dipped, reports of retail sales are generally positive. Manufacturing growth is leveling off. Real estate markets are sluggish. In the resources sector, firming oil prices have helped the energy-producing districts, while environmentally-related legal issues are said to have restricted lumber supplies. Recent rains have alleviated drought problems in several districts. Loan growth varies considerably across regions. A number of districts mention undesirably high inventories, particularly in autos. With some exceptions, wage and price pressures are not accelerating. Some districts said their respondents had not been able to pass their input cost increases through to their customers.

Consumer Spending

Retail sales reports are mixed, but the tone is generally positive. Cleveland mentions that sales in Ohio rebounded in May, and that gains continued into June. Demand has picked up in the Kansas City district. Dallas and New York note year-over-year gains, and Minneapolis cites strong consumer spending. Boston, Chicago, and Philadelphia offer less positive comments, however. Strength in sales of women's apparel was noted by several districts, but consumers appear to be increasingly cautious about purchases of big-ticket items.

Auto sales have weakened. Philadelphia, Cleveland, Richmond, Chicago, Kansas City, and San Francisco all note softening demand, while Atlanta mentions undesirably high inventories among dealers. Dallas cites moderate

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sales growth and Minneapolis also refers to recent expansion. San Francisco reports that demand is strong in some parts of its district, although not in most of them.

Manufacturing

Growth in manufacturing activity has slowed. Boston, Philadelphia, Richmond, and St. Louis all note evidence of reduced rates of expansion, although San Francisco reports robust activity. Boston, Dallas, and San Francisco mention negative impacts of reduced defense contracting. Several districts also refer to weak demand for construction-related products. Nevertheless, a number of sectors remain strong and have high rates of capacity utilization. San Francisco reports bottlenecks in the commercial aircraft industry and tight capacity at most paper mills. Chicago and Cleveland note strong capital goods orders and Atlanta cites upward revisions in capital spending plans by several manufacturers. Most plants in the St. Louis district are said to be operating near full capacity. Although Atlanta and Boston say export demand is strong, a number of other districts cite concerns over potential or actual softening of export markets for some industries. Some districts mention rising prices of basic inputs, particularly metals and certain plastics.

Construction

Construction is showing signs of sluggishness. Boston, New York, Minneapolis, Kansas City, and St. Louis mention evidence of slipping residential real estate markets. Nonresidential activity shows greater variance across regions, with high rates of industrial construction in the Chicago district and with strong commercial real estate markets in the coastal states of the San Francisco district. In Arizona, which is also in the San Francisco district, commercial and residential real estate markets are languishing. Although Manhattan is undergoing a spate of hotel-building activity, loan officers in the southern portion of the New York district say their commercial real estate markets are generally quite weak. Dallas mentions that nonresidential construction is unchanged at a low level, while Philadelphia reports that commercial real estate markets there are softening.

Resource Industries

Conditions in the resource sector vary among individual industries. The recent firming of oil prices is said to have helped the energy sectors in the Atlanta, Kansas City, and Dallas districts, while St. Louis reports some increases in coal output. Minneapolis, however, notes that the wood products industry's access to local raw materials has been severely limited as a result of environmental concerns. San Francisco mentions that legal issues have contributed to a reduction of lumber production there, but that exports of logs have also contributed to the slowdown.

Agriculture

In agriculture, the most significant news may be the recent rains, which have helped to alleviate drought problems in several districts. Subsoil moisture levels remain a cause of concern, but past difficulties have been reduced by precipitation in the St. Louis, Kansas City, and Dallas districts. The rains came too late to avert considerable damage to the winter wheat crops in the Dallas and Kansas City districts, where past dry weather has also motivated ranchers to reduce their herd sizes. Wheat yields in some other districts, including Richmond and Minneapolis are expected to be high.

Banking

Financial industry activity varies markedly among the districts that mention banking conditions. New York notes that loan demand at small and medium-size banks is the same or somewhat weaker than a year ago. Commercial loan demand in the Richmond district remains unchanged, compared with modest growth in the first half of April, while consumer credit demand there is up modestly. Loan volume in the Philadelphia district is growing, but at a slower rate than during the first quarter. In May, loan demand surged in the Cleveland district. Loan demand in the Kansas City district is also increasing, while St. Louis notes improved bank profitability and asset quality. In the San Francisco district, commercial loan demand is increasing and most western banks are posting strong profits.

FIRST DISTRICT-BOSTON

Manufacturing activity in the First District remained soft in April and May, with new orders showing little growth from year-ago levels. Retail results were mixed, but customers are characterized as cautious. Some firms have cut capital spending plans; others are proceeding to expand operations. Price increases, except for selected materials, are reportedly moderate. A new forecast for the region predicts continued job growth through 1991, albeit slowing in 1989 and 1990.

Retail

First District retailers report a variety of sales results for May. Some respondents enjoyed double-digit increases from year-ago levels, while others saw their receipts decline. In general, retailers find customers becoming cautious. Moderate-priced, discounted, and heavily promoted items are doing especially well. Sales of men's clothing have weakened, while women's clothes are bouncing back.

Prices are generally stable, respondents report. While prices of some hardware items are edging higher, promotions are pulling other prices down. Profits are also steady, as sales increases or cost cuts have offset declines in gross margins. Labor costs have also stabilized. While contacts still consider the labor market tight, they report lower turnover rates and an improvement in the quality of new hires.

Half the retailers surveyed expressed optimism about the remainder of 1989. These firms continue to expand, but with caution. Financing is available, and real estate developers are actively seeking tenants. Nevertheless, several contacts view New England retailing as overbuilt and highly competitive. They worry that firms that took on large debts during a corporate restructuring were weakened in the process. One wholesaler also noted a rise in receivables and expressed concern over the strength of its small retail customers.

Manufacturing

For many First District manufacturing contacts, business activity in April and May slowed from its previous pace. However, several firms sensed a modest pick-up at the end of the period. Sales ranged from 12 percent above to 12 percent below year-ago levels, while orders were generally flat. Demand for construction-related products and most defense and consumer goods has been relatively weak. By contrast, industrial demand has stayed relatively strong, and computer-related activity may have stabilized recently. Exports also remain strong. Half the firms expressed concern about the dollar's recent rise, but the others believe that foreign demand for their products is not price-sensitive.

As a result of the recent softness and continuing productivity gains, employment levels are generally flat to down slightly. Observers in defense- and computer-related industries expect "downsizing" to continue. Similarly, over half the respondents have pared capital spending plans by 10 percent or so from previously forecast levels. Capital purchases include buildings as well as equipment, with some expansions located in New England. Inventories remain satisfactory.

First District manufacturers continue to complain of increases of 10 percent or more in the cost of certain materials, including nickel and other metals, plastic feedstocks, packaging materials and ball bearings. Most contacts say that they cannot pass these cost increases through to their customers. A few have succeeded raising their sales prices between

1 and 5 percent.

First District manufacturers describe their outlook as "guarded." Most expect GNP to be virtually flat for the rest of the year; however, several contacts believe that their own firm will outperform the economy.

Residential Real Estate

Residential real estate sales slowed in May and are below year-ago levels. Realtors believe that concerns about the regional economy have contributed more to this weakness than have higher interest rates. Nevertheless, both factors have reduced demand at a time when the inventory is large because of previous heavy building.

The fall-off in sales is concentrated in condominiums and mid-priced homes ($150,000 to $250,000), but one contact reported price declines at the high end of Boston's suburban market. Most realtors foresee stable residential sales through the summer, with a small seasonal improvement possible.

Outlook

The New England Economic Project (NEEP) held its semi-annual outlook conference in late May. The NEEP forecasts for the New England states call for nonagricultural employment to grow more slowly in 1989 than the 2.1 percent pace of 1988. Mirroring the national outlook, further slowing is expected in 1990, followed by a pickup in 1991. Nonmanufacturing jobs will continue to expand over the forecast period, while manufacturing employment will shrink until late 1990. Although unemployment will inch up, NEEP forecasters expect the region to remain prosperous, with unemployment rates well below and per capita income considerably above the national average.

SECOND DISTRICT--NEW YORK

A mixed pattern of developments in the Second District economy continued during recent weeks. District retailers had over-the-year sales gains during both April and May, though the extent of the increases varied widely. Unemployment rates in District states have seesawed recently but are currently at or below the national level. While office leasing activity picked up further, homebuilders reported a slower pace of construction. Most small- and medium-sized banks reported that demand for commercial loans is generally the same or somewhat weaker than a year ago.

Consumer Spending

District retailers reported over-the-year sales gains during both April and May though the extent of the increases varied widely. April gains ranged between 2.7 percent and 13.6 percent while the May range was from 0.5 percent to 6.6 percent. Several contacts described their April sales as well above plan but a few found theirs disappointing. May results were generally below or just about on target. Among items in strong demand at District department stores throughout the period were women's apparel, accessories and cosmetics. Men's apparel and home furnishings also sold well in April but demand for them slowed after that.

Inventories at the start of June were characterized by most respondents as satisfactory, though in one case only as a result of heavy markdowns during recent promotionals. This retailer remarked that profit margins at many stores are increasingly being squeezed by higher import and supply prices on the one hand and customer resistance to paying for these costs on the other.

Business Activity

District unemployment rates have seesawed in recent months but currently are at or below the national level with a May reading of 5.3 percent in New York and

3.0 percent in New Jersey. (The New York rate averaged 4.2 percent last year, however.) In New York, spokesmen for Grumman now predict that as many as 10,000 to 15,000 jobs would be lost on Long Island if the Pentagon carries out its plan to cancel several Navy aircraft contracts.

Some 40 percent of purchasing managers in Buffalo and Rochester reported improved business conditions in May, unchanged from the last surveys. However, in Buffalo, there was also an increase in the percentage of firms with worsened conditions.

Several large projects were announced in the District since the last report. An aluminum company will invest $175 million over the next three years to modernize a sheet-producing plant north of Syracuse, and General Electric will produce eight steam turbine engines at its Schenectady facility as part of a $750 million order from a foreign utility company. Elsewhere, the Yonkers City Council gave final approval to a $300 million waterfront project which will include apartments, a shopping mall and various recreational facilities, and the Islip Town Board approved a master plan for redeveloping an 800-acre former state hospital into a mixed-use complex composed of industrial, office and retail space, a hotel, housing, recreational facilities and an expansion of the New York Institute of Technology campus. Newark was the site of several recent developments: construction was begun on two shopping centers; Seton Hall University will build two office towers and expand its law school in conjunction with a development corporation and the city; plans were also announced for a $130 million office, hotel and retail complex to be linked by "skyways" to the nearby railroad station.

Residential Construction and Real Estate

District homebuilders report a slower pace of construction activity in recent weeks. In some areas where builders earlier had been quite busy, this slowing was attributed in large part to unusually rainy weather, which deterred potential buyers from looking and restricted the amount of construction which could be done. In other areas, however, where large inventories of homes for resale exist, demand for new homes continued weak in the face of buyer resistance to high prices. Some observers noted a pickup in the remodeling and expansion of existing homes by owners unwilling to reduce their asking prices. While the current lull in the housing market is viewed by many as an inevitable part of a cycle following several years of substantial strength, the recent decline in interest rates has generated hope that an upturn in buyer enthusiasm will occur.

Office leasing activity picked up further in recent weeks and both downtown and midtown Manhattan had volume well above year-earlier levels. Despite strong leasing, however, Manhattan vacancy rates showed no improvement because of the large amount of additional space recently put on the market. Office vacancy rates did edge down in some parts of the District such as northern New Jersey and Fairfield and Nassau counties.

Manhattan is currently undergoing a spate of hotel-building activity in areas which, until recently, had been deemed unlikely locales. Three hotels are under construction near Times Square, where the first new hotel opened four years ago, and two others are going up in the Wall Street area, where the first hotel opened eight years ago. New developments such as tourist attractions, a convention center, and a cluster of new office buildings are credited with turning these areas into more viable hotel sites.

Financial Developments

Based on a survey of senior officers at small- and medium-sized banks in the Second District, demand for commercial loans is generally the same or somewhat weaker than a year ago. Most officers did not believe that the rise in interest rates over the past year substantially dampened commercial loan demand. In their opinion, other factors such as projected sales and expectations of future economic conditions are probably more crucial in expansion and modernization plans of firms and the subsequent loan demand. With regard to particular types of commercial lending, bankers in upstate New York tended to report strong demand for construction loans while those in the southern portion of the Second District stated that the commercial real estate market is quite weak. However, except for the real estate sector, most respondents believed that their local economy is basically healthy, though only a few noted strong growth. The majority of those surveyed expect demand for commercial loans to remain stable through 1989, barring a sharp fall in interest rates.

THIRD DISTRICT - PHILADELPHIA

Indications from nearly all sectors of the Third District economy surveyed in June reveal little, if any, growth in recent weeks. Manufacturers report that both new orders and production activity have been virtually steady since April. Retailers say current dollar sales are generally running just even with the pace of last spring. Bankers indicate that growth in loans and deposits continues, but at a slower rate since May than in the first four months of the year. Realtors say that home sales in April and May were very sluggish but appear to be picking up with the recent drop in mortgage rates; however, commercial real estate markets are beginning to show signs of weakening.

The consensus outlook for the region's economy is for stable conditions, at best, through the summer. Manufacturers forecast steady to slightly slower activity for the second half of the year, and they are planning cuts in employment and smaller increases in capital spending. Retailers expect sales in the second half to run even with or fall below the current pace, in real terms. Bankers expect slower growth in loan demand from both businesses and consumers and they plan to reduce commercial real estate lending as well.

MANUFACTURING

Third District manufacturers contacted in late May and early June generally report that business continues to run at an even pace, as it has since April. Just over half of the firms surveyed indicated steady business as June began and the rest are evenly divided between those noting a pickup since May and those for whom business slowed. While the overall picture is one of no change, durables producers are experiencing a drop-off in activity while nondurables producers are seeing some improvement.

Firms in the region have seen a leveling off in the rate of new orders in the past few weeks, in contrast to the steady growth they had been experiencing, and order backlogs are falling as shipments continue on an upward trend. Nevertheless, inventory reduction, which had been reported for several months, appears to have stalled in June. Despite these indications of slackening demand for manufactured goods, industrial firms in the region are maintaining employment levels, although working hours are being trimmed at some plants. On the price front, increases in input costs are noted by nearly half of the companies contacted for this report and about one-quarter are raising the prices of their own products. These indications of price increases are not quite as widespread as they had been earlier this year.

Looking ahead, sentiment among Third District manufacturers is widely divided but, overall, slightly negative. On balance, managers at area plants forecast slower business during the second half of the year, with new orders running just steady and shipments declining as order backlogs are worked down. In line with their forecasts of reduced output, local firms plan to trim payrolls and working hours somewhat by year-end, and they intend to reduce inventories as well. Capital spending plans still call for increased outlays over the next six months, on balance, but compared to reports over the last twelve months, fewer firms are boosting spending and more are cutting back on plans.

RETAIL

Third District merchants generally report that sales in May were only about even with the same month a year ago, in dollar terms. Although women's apparel sales continue to improve, sales in most other lines of goods are disappointing. Discount stores are achieving somewhat better results than other types of stores, but nearly all retailers contacted in early June describe consumers as cautious and reluctant to step up spending. Auto dealers have seen sales slip despite manufacturers' incentives, and many dealers are cutting back on orders to the factories in an effort to keep inventories under control.

Retailers expect a soft summer, and some predict that the year-over-year gain in unit sales for the second half will drop below the increase posted in the first half. For 1989 as a whole, area merchants are in agreement that sales will increase by only a few percent above 1988, in dollar terms. With expectations receding, retailers are trimming inventories, cutting orders, and holding the line on hiring.

FINANCE

Total loan volume at major Third District banks in mid-May was approximately 11 percent above the year-ago level as growth eased from the 13 percent year-over-year gain for the first quarter. Lending to both businesses and consumers continues to increase, according to bankers contacted in early June, but they note some slackening in the upward pace and they expect further slowing of growth in these loan categories in the second half. Real estate lending remains fairly strong, with rising commercial construction loans making up for slower growth in residential mortgage lending. Bankers say concern for credit quality in commercial real estate is growing, however, as rents and occupancy rates appear to be declining, and they expect to cut back on commitments for commercial real estate financing in the months ahead.

Deposit growth at major Third District banks has slipped in the past month, according to bankers, but not by as much as asset growth has, so bankers generally do not express concern about gathering funds. Demand deposits declined for most banks in May, and bankers attribute this to consumers shifting to interest-bearing accounts in response to the first quarter increase in interest rates and to increased use of cash management services by corporate customers. Time deposit growth is described as healthy. Several banks are promoting certificates of deposit, especially in 9-month to 2-year maturities, and they are gaining significant deposits with rates of up to 10 percent for the 2-year term.

REAL ESTATE AND CONSTRUCTION

In most areas of the Third District, realtors say sales of residential properties are running well below last year's pace and price appreciation is only marginal. The usual spring upturn in sales did not materialize this year, according to realtors surveyed in early June, but some note signs of a pickup with the recent drop in mortgage rates. Nevertheless, some realtors say sales will not regain much strength because would-be first-time home buyers are hampered by an inability to make the typical 20 percent downpayment, despite having incomes that would qualify them for substantial monthly payments.

Commercial real estate in the Third District is also showing some signs of softness. Office occupancy rates remain fairly healthy in the Philadelphia central business district, according to realtors, but plans for several major new buildings have been postponed. In the suburbs, vacancy rates are rising for both office and retail space, but construction has not slowed significantly. Industrial construction contracts awarded since April have fallen below the first quarter rate, according to builders, but remain above the value of contracts let during the spring of last year.

FOURTH DISTRICT - CLEVELAND

Summary. Most of the forecasters who attended the latest meeting on the economic outlook at this Bank still expect a slow growth path in output accompanied by a 4.5% rate of inflation well into 1990. District respondents report strengthening in retail sales in May, although auto sales were less than expected. The pace of manufacturing appears to be slowing. Interest rates are generally expected to ease further.

Economic Prospects. Economists who attended the quarterly meeting of the Fourth District Economists' Roundtable on June 2 still expect a soft landing for 1989-90. The 27 forecasters, who represent industry, trade and financial institutions inside and outside this district, expect a 1.5% growth rate in output into mid-1990, a little less than they expected at last February's meeting, and a step-up to a 2.5% annual rate of increase in the second half of 1990. Individual forecasts range from a supply-constrained 2.5% growth rate in output to a mild recession beginning in 1989. A few expect a recession, beginning this quarter or next, similar to the mild recessions in 1960-61 and 1969-70.

A common thread in most of the forecasts is the persistence of inflation at about an annual average rate of 4.5% through the end of 1990. A concern expressed by some of the group is that the rate of inflation will not slow once it builds, and that it will not easily slow unless there is some slack in the economy. Therefore, an issue raised by discussants is whether there is greater cost if the inflation rate climbs to 6% or if the unemployment rate climbs to 6%. Some felt that policy risks must be taken now to lower the inflation rate; otherwise, inflation will build in the absence of slack. A few also cautioned that an easier monetary policy would risk accelerating inflation in a full employment economy.

Consumption. Two large retailers report their sales in Ohio rebounded in May and that gains are apparently continuing into June. One reports a sizable year-over-year increase in sales, except for weak sales of home electronics and appliances. Another retailer reports a better May, including sales of home electronic products, which may be more competitively priced because of alternative overseas sourcing when Japanese import prices rose rapidly. That retailer reports high inventories and plans to aggressively promote sales in order to cut stocks. A retail trade economist expects real consumer spending will increase less than 2% this year. His studies show interest rates now have little effect on consumer spending for either durable or nondurable goods.

Auto retailers describe consumer responses to the latest round of incentives as lackluster and worse than expected. Incentives initially boosted new car sales but consumer interest since then has waned. Dealers generally complain of squeezed profit margins partly because of interest costs on unsold inventories, which have also resulted in some dealers offering cars at about cost. Dealers contacted expect that their orders for 1990 models will be conservative because of a likelihood of high inventories of 1989 models going into the new model year.

Manufacturing. Orders and production generally remain strong, although some easing from full capacity levels is reported, in part because of summer vacations. Purchasing agents in Cleveland and Cincinnati report a reduced pace both in manufacturing activity and commodity price increases. Some also report slower growth in exports.

Capital goods respondents report that business remains strong and has been unaffected by interest rates. One producer expects business spending for durable equipment to be only slightly less this year than last. He expects that capital stock will increase faster than industrial output this year,

thereby easing pressure on operating rates and on producer prices. Another producer reports no let up in orders for electrical equipment. Prices might increase a little more this year despite ample capacity as producers attempt to recover some of the higher costs of copper and aluminum. A machinery producer reports production schedules for domestic purchasers are leveling out, availability of materials is improving, and price pressures are showing some signs of easing.

Steel producers also note some let up in activity from consumer durable and capital goods producers. Summer vacations, auto changeovers, and some softening in demand for steel are expected to reduce steel shipments next quarter from this.

Financial Developments. Several respondents believe that the peak in short-term interest rates for this year will be in the second quarter, and one bank economist expects that the funds rate could move downward to 9% by yearend. Some respondents cautioned, however, that interest rates could rebound if premature easing by the Federal Reserve were to result in stronger economic growth and further acceleration in prices.

Some banks report that loan demand surged in May, despite higher interest rates, and speculated that business loans were being used to finance inventories. The latest decline in the prime rate is not expected to change loan activity much, even though loans tied to the prime rate will also be adjusted slightly downward. Some mortgage lenders and a producer of household appliances expect that recent declines in mortgage rates, which may result in a better-than-previously-expected level of housing sales and starts.

FIFTH DISTRICT-RICHMOND

Overview

The District economy showed signs of slower growth in May, following its earlier deceleration in April. Retail sales were generally lackluster, although some department stores reported increases. Manufacturing activity grew at about the same pace as in April, which had been slower than earlier this year. Residential construction remained soft, and bankers reported little growth in loans. Exports rose at the three major District seaports, while imports declined or remained unchanged. On District farms, planting activity progressed rapidly in recent weeks.

Manufacturers and retailers expect a deterioration in the trade balance and little change in the rate of increase in prices and wages in the next few months. Bankers expect inflation to remain in check.

Consumer Spending

According to our regular mail survey, District retail activity slowed further in May. There was little change in the proportion of respondents who reported increases in sales, but the proportion of those who reported declines rose. More than half of the retailers expect sales to rise in the next six months.

Retail activity differed by type of store. Most car dealers indicated declines in sales. Sales at department stores apparently improved in May, however, as almost half of the respondents reported increases. Big ticket items did not sell well at department stores in May but are expected to do better in the next six months. None of the department store respondents expected sales to decline in the next six months.

Manufacturing

District manufacturing activity continued to grow in May at April's pace, which had been slower than in previous months. About half of the respondents to our regular mail survey reported no change in activity. Among the other half of respondents, those who reported increases in shipments, new orders, and employment slightly outnumbered those who reported declines; however, more respondents reported declines than increases in unfilled orders and the length of the workweek. Prices for both finished products and raw materials apparently continued to rise at about the same rate as in April.

District manufacturers are guardedly optimistic about prospects for growth in their businesses in the next six months. Respondents who expect increases in sales outnumbered those who expect declines, but more expect decreases than increases in employment, unfilled orders, and the length of the workweek. With regard to general business activity in the nation, more respondents expect decreases than increases in the next six months.

Inflation and Trade Expectations

We asked manufacturers and retailers in the District to indicate their expectations about U.S. prices, wages, exports, and imports in the next six months. The results are summarized in the table below.

	Respondents Expecting Rate of Increase to:		
	Rise	Slow	Not Change
Prices	15%	26%	60%
Wages	21%	16%	62%
Exports	24%	42%	34%
Imports	32%	25%	43%

Housing

A survey of District homebuilders indicated that residential construction remained soft in many areas when compared to a year ago. Several respondents, however, noted that activity has picked up somewhat recently. Most of those surveyed expect the demand for new homes to increase in the next several months.

Financial

A telephone survey of bankers indicated that the demand for commercial and industrial loans was flat in many parts of the District in May compared with modest growth in the first half of April. Bankers in Charlotte continue to see strong loan activity. Consumer credit demand was reported to be up modestly, but several bankers noted weakness in automobile loans. Most respondents anticipate a gradual leveling of the economy, while none expects a severe downturn. Further, none of the bankers surveyed expects a significant acceleration of inflation.

Port Activity

The three major District seaports--Hampton Roads (Norfolk), Charleston, and Baltimore--reported increased exports in May as compared with April, and two of the three reported decreased imports. Port representatives noted that compared to a year ago, export activity was greater while import activity was generally unchanged. Representatives from Charleston and Baltimore expect export activity to continue to outpace import activity during the next six months. A representative from the Port of Hampton Roads, however, expects little change in the ratio of exports to imports in the next six months.

Agriculture

Drier weather throughout much of the District has enabled spring planting activity to progress rapidly in recent weeks. As the harvest of winter wheat approaches, most areas look for high yields. Fruit and vegetable crops are generally rated fair to good, and early prospects for the hay crop are also good. In most areas of the District, farmland prices continue to rise.

SIXTH DISTRICT - ATLANTA

Overview: Firms headquartered in the Southeast continue to report business activity growing although many believe that it will slow. Reported upward revisions in capital spending plans by several manufacturers, indications of producers' expanding capacity, and strong export demand provide evidence of continued growth. At the same time, there are also reports of undesired accumulations of inventories in construction materials, agricultural supplies, paper materials, automobiles and retail goods at department stores. On the price front, our contacts are indicating generally stable prices for most producer inputs used in their operations. Labor costs are an exception; contacts say that nonwage benefits have been rising rapidly and report that localized shortages of skilled and nonskilled workers are generating some upward pressure on wages.

Reports of Business Activity: Most of our contacts indicate that while business activity is still growing, its pace is slowing. A few contacts, primarily in export related sectors, indicated a recent increase in demand and corresponding plans to expand output. Several manufacturers have reported that they have recently increased their capital spending plans. A chemical producer is restarting an idle plant, while a plastics manufacturer is planning to purchase new equipment to expand output. Several oil companies operating in the Gulf of Mexico note that capital spending has been more rapid than expected as the result of oil price increases. Sixteen mobile drilling rigs have recently been put back into operation. On the agricultural side, strong demand for poultry has prompted one producer to expand processing capacity by 50 percent. Financial institutions are reporting a slight weakening in overall consumer lending and credit reference firms report no unusual trends in consumer credit, except reductions in new auto loans.

The Inventory Picture: The overall inventory picture as painted by our contacts shows some moderation in economic activity resulting in unanticipated inventory building in some sectors while other sectors continue to experience substantial growth and inventory tightness. Undesired accumulation was reported in weaker sectors of the economy. A supplier of building materials notes that inventories are higher than desired, as does a producer of chemicals used in construction. Stocks of crushed rock have started to accumulate, and one producer has cut production hours 15 percent. Producers are reporting increased inventories of some chemicals and plastics. Agricultural supplies have been building up as some farmers delay or cancel plantings due to heavy rains in the Southeast. Several financial firms noted increased loan demand to finance higher inventories at some department stores but especially at auto dealers.

To balance the inventory picture somewhat, reports of desired accumulation and tightness were also received. A paper manufacturer reports a buildup of box inventories, but this was intentional in anticipation of increased demand later in the year. Several large retailers indicated that inventories are at desirable levels. A producer of telecommunication equipment reported less than desirable stocks in part because of increased export demand. Because of higher demand for electricity and strong export demand, coal stocks are below the level desired by producers.

Price Pressures: Southeastern contacts do not report strong concern about price pressures. In fact, they indicate that partly as a result of unintended inventory accumulation, some downward pressures could develop. A producer of chemicals and plastics reports that increasing supplies of primary chemicals are expected to cause price reductions later this year. He added that the demand for certain thermoplastics and polyvinylchloride compounds has eased recently because of slowdowns in construction. A plastic container manufacturer who had earlier expected to raise prices did not because of an improved supply of resins and corrugated packaging.

Paper prices have recently backed off from the increased levels established early in 1989, and one producer anticipates further cuts. Weakness in the price of linerboard was also reported, and one paper manufacturer reports that while demand is strong, it is weaker than expected earlier this year. And a producer of wood pulp noted that his firm's price is currently 10 percent higher than that of some European producers.

Those surveyed report scattered labor market shortages but do not regard generalized wage pressures as substantial. Wage increases are generally reported below 5 percent. The cost of employee benefits, however, has been rising more rapidly and many contacts report they have been trying to reduce nonwage compensation to control costs, in particular, medical coverages for employee dependents is being restricted.

One respondent indicated that wages for unskilled, outdoor labor in Nashville are often well above minimum wage levels. Entry level workers for hotels and restaurants are in short supply, and a large Atlanta retailer reports that entry level wages have been under constant pressure, although productivity increases have so far offset wage gains. The shortage of registered nurses continues, with wages rising faster than inflation. One banker in Atlanta has found it difficult to locate experienced managers and skilled clerical help. A producer of lumber and paper indicated that mandatory Sunday overtime is being eliminated and that the firm has seen no unusual pressure on wages.

SEVENTH DISTRICT--CHICAGO

Summary. Indicators of overall business activity in the District are giving mixed signals. Payroll employment in the five states, through April, trended upward from late 1988 at a somewhat slower rate than last year, about in line with the nation. However, employment measured in the household survey for Illinois and Michigan fell in May for the third straight month. Chicago-area purchasing managers reporting increased production in May continued to outnumber those noting declines, but by a smaller margin than since early 1987, and orders and backlogs slipped. Motor vehicle sales below last year's pace, despite attractive buyer incentives, have prompted limited production cuts. Markets for many types of industrial machinery still appear strong, though weakening has been reported in some equipment markets, including light construction equipment, communications equipment, and some other electronic types. Industrial construction is strong in the region. Office construction continues at a brisk pace in downtown Chicago. Recent rains have improved crop prospects in most District states.

Equipment. Demand continues vigorous in many industrial equipment markets. Orders for industrial diesels, for applications other than in large trucks, are described as strong in domestic markets and for export, except from manufacturers of light construction equipment, reflecting the slowdown in housing construction. Demand at producers of highway construction equipment was characterized as very strong. Robust orders have been reported recently at foundries, metal fabricators, and machinery builders. Incoming orders for machine tools have slipped, particularly from foreign buyers, but backlogs remain far above year-earlier levels. One large machine tool builder expects its order backlog to support continued increases in shipments in this year's second half. Orders have weakened for communications equipment and some other electronic types.

Construction. Indicators of construction in the District continue to show a relatively robust pace of activity. For example, year-over-year increases in shipments of cement and gypsum board to District states have been larger than nationwide (though this partly reflects the mild January weather in the region). Strong demand for downtown Chicago office space and relatively few completions of new buildings this year have lowered the vacancy rate (as defined in two recent surveys) to less than 10%, encouraging plans for additional buildings. The market for Chicago-area industrial property is also strong. In Detroit, ground was broken recently for a $1 billion auto assembly plant, a replacement for an aging plant. Preliminary site work is very strong for office buildings and industrial facilities in the Milwaukee area. Construction activity on houses is said to be holding up well around Chicago but sales of existing homes slipped this spring as mortgage interest rates climbed above 11%. Rates typically offered on 30-year fixed-rate loans have since fallen to a 10% to 10-1/4% range, and below 10% at some area lenders.

Motor Vehicles. Sales of motor vehicles continue to trail year-ago levels despite recently enhanced incentives which a contact described as the most attractive for buyers in at least 2-1/2 years. Extended model changeover shutdowns have been announced for some District assembly plants; another plant was recently shut for one week to control inventories; and a planned start-up of a second shift at a car assembly plant was cancelled. But overall production cutbacks have been modest. Heavy truck plants have been running close to effective capacity.

Steel. Steel demand continues strong. A Chicago-area integrated mill is hiring summer help, for the first time in about a decade, to cut excess overtime of regular employees. However, there have also been reports recently of some slippage in orders, perhaps only seasonal. Steelmakers have announced additional large investments, including another new plant to be built in Indiana and major upgrading of an existing facility in that state.

Retailing. A contact described retail sales recently as satisfactory, but generally less so than earlier this year. Cooler weather may have deterred some retail sales in the Midwest in May. This retailer viewed consumer spending as supported by good income gains this year, but indicated concern about surveys showing increased consumer pessimism regarding inflation, interest rates, and home buying prospects.

Agriculture. Early season crop prospects over most of the District have benefitted considerably from recent rains. In Indiana, however, the rains have further delayed the wind-down of the planting season and stressed some early-planted crops. Late spring frosts apparently caused some fruit and vegetable losses in Michigan. While no official tabulations have been made, some observers characterize the losses as "less than expected."

Labor Markets. District labor market conditions show considerable diversity. Unemployment has declined in the District, as utilization of labor resources has pressed against available supply in many areas. Unskilled industrial labor, for example, is in tight supply in Chicago's western suburbs, and pay levels have been pushed upward, squeezing profits of employers competing with firms in lower labor-cost areas. The seemingly chronic shortage of some industrial skills, such as experienced welders and machinists, may have been exacerbated by the industrial upturn of the past 2 years. Employers in local areas where labor is tight--parts of Indiana, for example--are advertising for skilled workers in areas where there were sizable lay-offs a few years ago. Job-hopping in pursuit of higher pay reportedly has increased. But employers in some industries continue to press for concessions, indicating a willingness to shut facilities or replace striking workers in order to bring down labor costs, in some cases citing costs at competitors. Industries in the District in which this has been taking place include auto parts manufacturing, grocery stores, and truck transport. Jobs remain hard to find in some white-collar occupations. Staffing cutbacks or curtailments on hiring continue in response to, or to stave off the threat of, corporate reorganizations.

EIGHTH DISTRICT - ST. LOUIS

Summary

Employment growth has declined because of slower job growth in manufacturing and services and job declines in construction. Current agricultural conditions indicate that normal crop yields are possible this year. The rise in the value of the dollar has not had a significant effect on District exporters. District banks report stronger profits propelled by lower loan loss provisions and lower loan losses.

Labor Markets

District employment growth has slowed. In the three months through April, District nonagricultural employment rose at a 2.3 percent annual rate, less than half the rate for the previous three months and slightly slower than the national average. The District slowdown was particularly sharp in Missouri and Tennessee.

Manufacturing employment growth has slowed throughout the District. In Missouri, manufacturing employment in the February-April period declined slightly from the previous period largely due to job declines in food processing and a layoff in an auto assembly plant to reduce inventories. Automobile employment will decline this summer as two St. Louis auto assembly plants close for one month. Although auto assembly plants typically close for one or two weeks each summer to retool assembly lines for the next model year, analysts suggest the longer shutdowns this year are to reduce inventories.

Exports

A District bank and exporters involved in plastic production, food processing, electrical motor manufacturing and grain handling report that the recent rise in the dollar has not significantly affected exports. Long contract periods were frequently cited as the reason for the minimal impact. One large lumber products manufacturer, however, noted that exports to Europe, especially plywood, have dropped by as much as 25 percent from a year ago, largely due to the rise in the value of the dollar. In addition, some exporters expressed concern about future export sales if the dollar continues to rise.

Construction

The value of residential construction contracts issued in the three months through April has fallen 3.7 percent from the same period last year both regionally and nationally. During the same period, nonresidential contracts dropped 14.5 percent in the District and 2.7 percent nationally.

In St. Louis, labor strikes shut down most commercial and residential construction projects for two weeks. St. Louis metropolitan area office vacancy rates, currently below the 1988 national average, are expected to rise sharply in 1989. The quantity of new space demanded in 1989 is expected to decline from 1988 levels while the volume of new space will almost triple.

Outlook

A recent survey of District small businesses reveals a more pessimistic outlook than a year earlier. Almost twice as many businesses think economic conditions will worsen rather than improve in the next six months, while in April 1988, roughly equal numbers expected a worsening or expected improvement. Consistent with these views, more respondents expect declines in their real sales volume than a year earlier and fewer plan to increase the size of their workforce. Finally, even though a smaller proportion planned to increase average compensation to their employees than in the earlier survey, a larger proportion planned to raise their prices in the following three months.

Agriculture and Mining

Topsoil moisture conditions are reported as adequate in most of the District, while subsoil moisture conditions are still short in some areas, most notably in northern Missouri. Most of the District's wheat, corn and cotton crops are in fair to good condition. District coal production for the four months ending in April was 3.5 percent higher than the same period last year. Industry analysts expect annual coal production to run about 2 percent to 3 percent ahead of last year.

Banking

First quarter data indicate improved profitability and asset quality for Eighth District banks. With net earnings rising 10.3 percent over first quarter 1988, annualized returns on assets and equity improved. Nineteen fewer banks reported negative earnings during this year's first quarter in comparison to the same period last year. Helping to boost earnings were lower loan loss provisions and lower loan chargeoffs. First quarter loan losses decreased 80 percent from the same period in 1988. Nonperforming loans, however, increased slightly as banks reported growing problems in commercial real estate loans.

NINTH DISTRICT--MINNEAPOLIS

Ninth District economic conditions have been generally good. The employment situation has been fairly good throughout the district. Consumer spending has been generally strong, but housing activity has been weak. Conditions in resource-related industries have been good.

Employment

The employment situation has been fairly good throughout the district. The unemployment rate in Minnesota in April was 4.7 percent, 0.2 percentage points higher than in March and 0.9 percentage points higher than in April 1988. The unemployment rate in the Minneapolis-St. Paul metropolitan area rose to 3.8 percent in April, compared to 3.5 percent in March and 3.0 percent in April 1988. The Minnesota State Government predicts that the closing of a large computer manufacturer's supercomputer division located in St. Paul will have major effects on employment in the state. The state's analysis suggested that, aside from the 800 jobs lost directly from the closing, 3,000 additional jobs could be lost from companies who supplied the division. A large local company engaged in the travel and hospitality industries reported that it expected to add about 1,000 jobs in the state. Some observers noted that while wages were edging higher for some entry-level service sector jobs, there was no evidence of any sizable increase in wage rates.

The unemployment rate in North Dakota fell to 4.5 percent in April from 5.2 percent in March and 5.0 percent in April 1988. The unemployment rate in South Dakota dropped to 3.5 percent in April from 4.2 percent in March and 3.7 percent in April 1988. The unemployment rate in Montana dropped to 6.1 percent in April from 7.6 percent in April 1988; in the Upper Peninsula of Michigan the unemployment rate in March was 10.5 percent compared to 11.7 percent in March 1988.

Consumer Spending

Consumer spending on general merchandise has continued to be fairly strong. One retailer reported that sales in May were 15.0 percent higher than a year ago; year-to-date sales were 16.0 percent higher than for the comparable period a year ago. Another retailer reported that sales in May were 6.1 percent higher than in its comparable stores a year ago. Inventories were also reported to be at acceptable levels.

Automobile sales recovered from low levels in the first quarter. Dealers for one domestic line reported that car sales were 19 percent higher and truck sales were 11 percent higher this May than a year ago. However, year-to-date sales of cars were only 2.5 percentage points higher and truck sales were 0.3 percentage points lower than in the comparable period last year. Sales of boats and other recreational equipment were reported to be sharply lower, with one dealer stating that April and May sales were the lowest in 20 years.

Housing activity was sharply lower than a year ago. The number of new housing permits issued in Minnesota in April was 26 percent lower than in April 1988. The number of new housing permits issued in the Minneapolis-St. Paul Area was 33 percent lower in April than a year ago. May home sales in the Minneapolis-St. Paul Area were 33 percent lower than in May 1988, though they were only 10 percent lower on a year-to-date basis. Contracts for future residential and nonresidential construction did not suffer as sharp a decline as did housing. The dollar value of such contracts was about 3 percent lower in May than in May 1988 and was approximately the same on a year-to-date basis.

All our contacts reported expectations of a strong tourist season. North Dakota, South Dakota, and Montana are celebrating their centennial year as states in the Union and were reported as expecting a good tourist season. One observer speculated that Yellowstone would draw many visitors curious to see the aftermath of last year's fire. Most of the tourist resorts in the Wisconsin Indianhead area reported being booked through October and reported the fishing season to have gotten off to a good start.

Resource-Related Industries

Conditions in resource-related industries have been good. North Dakota is expected to have a record grain crop. The winter wheat crop was excellent and, because the drought lowered yields in Kansas, it is expected that North Dakota will have the highest yield in bushels per acre in the country. A director described the winter wheat crop in South Dakota to be in pretty good condition. The subsoil moisture levels throughout the district were described as adequate to fairly good. Mining activity has been good; a director reported that a mining company in Montana was considering plans to start the world's largest silver mine. In the Upper Peninsula, feasibility studies on opening new copper mines were reportedly started. The wood products industry reported severely limited acess to lumber due to environmental concerns. In Montana, wood products output declined by 11 percent in the first quarter of this year compared to last year; this was primarily attributed to raw material shortages.

TENTH DISTRICT - KANSAS CITY

Overview. The pace of economic activity in the Tenth District remains relatively slow. Retail sales continue to improve, but new car sales are soft. Manufacturers' input prices are still rising, and availability is not a problem. Drilling activity, though modestly higher than in March, is still below a year earlier. Housing construction and home sales are relatively weak, and mortgage demand is low. Loan demand at commercial banks is flat to up slightly, and deposits are somewhat higher. The winter wheat crop will fall well short of normal, while prospects for spring crops depend on timely rainfall.

Retail Sales. Most merchandisers report retail sales performance has improved from a year ago and over the last three months, and they expect some additional improvement the rest of the year. Some retailers report price increases that reflect higher costs, and they expect further price increases in the future. Most respondents are satisfied with inventory levels and do not expect to make any changes. Automobile dealers generally report soft sales over the last month. Adequate dealer and customer financing is available, with some very attractive customer financing. Most dealers are trying to trim inventory levels because of soft sales. Sales are expected to continue at about their current pace.

Manufacturing. All respondents report input prices are higher than a year ago and three months ago. Most respondents expect little change, however, over the next three months. Firms report no difficulties in acquiring materials, and most anticipate no future problems with availability; some report longer lead times, however. Inventory levels are generally satisfactory. Most plants are operating close to full capacity, but no bottlenecks or labor shortages are reported.

Energy. While the recent firming in oil prices appears to have helped the district's energy sector, the industry remains cautious due to uncertainty about the implications of OPEC's recent meeting. After increasing sharply from only 211 in March, the average number of active drilling rigs in the district fell from 241 in April to 234 in May. Exploration and development activity thus stands about 10 percent below the level of a year earlier.

Housing Activity and Finance. District housing starts are down from a year ago, and most homebuilders report unchanged activity from a month earlier. Single-family construction continues to exceed multi-family construction. New home sales are down slightly, and prices remain about stable. Most respondents are uncertain about future activity because of uncertainty about future interest rates.

Most respondents from district savings and loan institutions report net outflows of deposits over the last month. Net deposit flows are generally similar to a month earlier, but are mixed relative to a year ago. Respondents expect deposits to be steady or lower in the near term. Mortgage demand is low in most areas and is generally expected to remain low. Some respondents attribute low mortgage demand and depressed real estate prices to sales of foreclosed properties by HUD. Nearly all respondents report slightly lower mortgage rates, but most expect fairly stable rates in the coming months.

Banking. District commercial banks report widely varied behavior of loan demand last month, with more respondents reporting increases in loan demand than decreases. While responses varied for all loan categories, some increase in consumer and home mortgage loan demand was apparent, as was a decrease in commercial real estate loan demand. District banks have begun to join in the recent reduction of prime lending rates, but almost no banks report changes in their consumer lending rates. Deposits grew last month, with the increase concentrated in large time deposits and small time and savings deposits; transactions deposits were constant or decreasing at most responding banks.

Agriculture. Crop growing conditions are a major concern in the Tenth District. Despite widespread rainfall during the past month, the district's winter wheat harvest is expected to be much smaller than normal. Wheat yields in southwestern Oklahoma, where the harvest is already nearing completion, are expected to be only two-thirds of normal. Wheat yields in Kansas and Nebraska are generally expected to range from a fourth to a half of normal, and severe drought in some areas has caused the wheat crop to be abandoned.

The small wheat crop is likely to reduce incomes of many district businesses, including grain elevators, where storage income has already been depressed by low grain inventories. Railroad cars used to transport grain sit idle in parts of the district. The financial condition of grain-dependent businesses now appears to depend on a more normal harvest of other crops.

Recent rainfall has improved prospects for pastures and spring-planted crops. Planting of spring crops in the district is nearly complete, and last month's rainfall improved growing conditions. Soil moisture reserves are low, however, and prospects for these crops depend on the amount and timeliness of rainfall during the rest of the growing season. Dry weather has produced poor grazing conditions throughout the district. Diminished feed supplies are leading some ranchers to sell more cattle than normal to reduce the size of their herds. Still, few herds have been completely liquidated as a result of feed shortages.

ELEVENTH DISTRICT--DALLAS

The District economy continues to expand at a modest pace. Demand for manufactured products is growing slowly. Retail sales increases are strong and auto sales expansion is moderate. Construction activity shows little change in either direction. The oil and gas drilling recovery continues. In agriculture, recent rains have moderated the drought.

Manufacturing output is expanding slowly overall. The turnaround in drilling activity last February has generated steady increases in oilfield equipment sales, particularly to export markets. Demand for primary metals is steady to up, with especially positive reports from foundry operators, a number of whom are adding capacity. Fabricated metal sales are also growing and respondents are very optimistic about orders for the rest of the year. Slowing defense-related activity has forced layoffs and hiring freezes at aircraft firms. Sales of defense-related electronics products are also softening. Elsewhere in the electronics industry, semiconductor sales have shown little recent growth, but makers of other electronics-related products cite upturns in orders. Orders to construction-related manufacturers -- including those in stone, clay and glass and lumber and wood products -- continue at a sluggish pace. After adjustment for seasonal factors, apparel producers have had little recent sales variation. A number of food products firms have been raising prices lately, despite little recent growth in input prices, and industry revenues are up. Chemical demand has been leveling off recently, but sales remain above a year earlier. Capital spending projects continue in this industry and labor shortages are becoming a concern. Oil refinery production is showing little change overall. Paper industry output continues near full capacity, but respondents note some softening in the high level of demand, as reflected in a reduction in the backlog of new orders. Paper producers are concerned about the impacts of the rise in the dollar upon their export markets. Although an increasing number of manufacturers say that wage pressures are rising, such respondents are still in the minority. Firms citing upward wage pressure say it has been accelerating in recent months, particularly in the chemical-producing areas of the Gulf coast.

Retail sales show strong year-over-year expansion. Rates of growth are particularly high in west Texas and on the Mexican border, but increases elsewhere are the rule, rather than the exception. Retail sales in Houston are estimated as having grown between 8 and 10 percent from a year earlier and sales in Dallas have also been increasing markedly.

Despite a national slump in new car sales, District auto sales are growing. Sales in Houston for the first four months of this year are up 9 percent over a year earlier and dealers expect this rate of expansion to persist. Dallas dealers say their sales are also growing and that, even without the recent rebate and interest incentive programs, they think demand would have increased. One respondent said that domestic automakers are learning not to take advantage of the appreciation of the dollar to push up prices, but are now going for market share instead.

Construction activity remains weak, but shows no consistent pattern of either growth or decline. Nonresidential contracting is essentially unchanged, while residential construction values have rebounded somewhat from their weakness of early 1989. Nonbuilding construction, for such structures as roads and public works, continues to slide. Although existing home sales continue to rise, median residential prices in most metropolitan areas are falling. An exception is Houston, where both construction activity and real estate prices have rebounded with the recovery there. Office vacancy rates continue to edge down in most metropolitan markets except San Antonio, where vacancies are still rising. Construction employment declines in Texas have leveled off, but they show little evidence of a rebound.

Oil and gas drilling continues its recovery. After declining from June 1988 until January of this year, the District rotary rig count increased in every month from February through May. Although the rig count remains 17 percent less than a year earlier, it has increased 23 percent since January. In recent months, oil prices have remained relatively stable in the $20 per barrel range. Respondents believe that the recent OPEC meetings are likely to have little effect on the price of oil and that drilling should increase mildly over the next few months.

Rains have improved growing conditions for much of District agriculture, but subsoil moisture remains low in large portions of Texas and New Mexico. Although the rain has accelerated the growth of field crops, it was accompanied by hail, wind, and flooding that damaged some grain and livestock operations in south central and northwest Texas. Despite the increased moisture, a combination of continued dryness in some cattle producing-areas and high feed prices has motivated substantial herd liquidation. The increased moisture came too late to help the already damaged District wheat crop, which is estimated to be the smallest since 1978.

TWELFTH DISTRICT -- SAN FRANCISCO

Summary

The pace of growth in the Twelfth Federal Reserve District continues to be healthy, with mixed signals regarding a possible slowing rate of growth. Despite the relatively good condition of the District's economy, two thirds of the business leaders contacted expect weakening national growth during the next four quarters. Consumer spending growth is reported to be healthy overall, despite weakness in sales of "big ticket" items such as cars, furniture, and home electronics. Manufacturing activity continues to be robust, with bottlenecks and tight raw materials supplies reported in several sectors. However, some early signs of falling export orders have emerged. Agricultural activity also is strong overall, despite rising prices for many inputs. Lumber production is falling as log supplies continue to tighten, but capacity continues tight at many paper mills. Real estate markets are strong in the coastal states, although a few respondents note heightened concerns or slowing activity associated with relatively high interest rates. In Arizona, however, commercial and residential real estate markets continue to languish. Most western banks report solid loan demand, while many banks are raising rates on certificates of deposit to attract sufficient funds.

Business Sentiment

Two thirds of the western business leaders contacted expect GNP growth to be weaker than its historical average during the next four quarters, although very few anticipate a recession. Most of the remaining third expect GNP growth close to its average pace. District business leaders still expect performance in the business investment and home-building sectors to weaken slightly during the next year, although they are more upbeat about these sectors than they were in the previous survey.

Consumer Spending

Consumer spending continues to grow at a healthy pace. Nevertheless, several respondents report a moderating rate of growth, which they attribute primarily to relative weakness in sales of such "big ticket" items as furniture and home electronics. Some retailers have expressed concern that inventories have gotten too heavy, while others report no inventory problems. Prices and wages are reported to be relatively stable, with prices held down in part by the recent increase in the value of the dollar.

Many respondents report weak car sales, although sales in some parts of the District are strong. No upward price pressure is evident, as incentives are required to keep sales volumes up.

Manufacturing

Bottlenecks continue in the commercial aircraft industry. Supplies are difficult to obtain, skilled labor is in short supply, and commercial aircraft ordered today cannot be delivered for about four years. Industry participants assert that these bottlenecks are putting upward pressure on Seattle-area wages and on materials prices. One aerospace executive reports that his firm's contracts with European and Japanese suppliers are priced in those nations' currencies, so the recent increase in the dollar's value has reduced his costs. In contrast, the cutbacks in defense spending are beginning to affect some California firms. One firm recently announced layoffs, and the competition for engineers reportedly has diminished.

Heavy machinery is selling well, with reports of increases in sales volumes of 10 to 15 percent above last year's levels. Some manufacturers report that material costs have risen 5 to 12 percent, due primarily to higher costs for aluminum, stainless steel and brass. One respondent notes persistent shortages of titanium dioxide and ethylene glycol, important raw materials for paints and coatings. List prices for paints and coatings have increased about 5 percent, but price increases negotiated for large projects are closer to 1 or 2 percent.

A California banker reports that some customers in Japan are starting to cancel orders for U.S.-made manufactured goods. Some of these customers have been faced with price increases of about 21 percent (5 percent reflecting US inflation and 16 percent due to currency changes). Other Japanese customers are asking for price reductions, but because most American companies' profit margins are too small to make sizable price concessions, they are opting to forgo some export business.

Agriculture and Resource-Related Industries

Agriculture generally continues healthy, although the costs of interest, machinery, fuel, fertilizer, and feed grains remain relatively high. Few changes in exports due to the higher dollar have been noted as yet.

Environmental and legal issues are combining with strong log exports to restrict log supplies and reduce lumber production. Capacity continues tight at most paper mills. However, new newsprint production capacity and soft newsprint demand have forced producers to back down from planned price increases this year, and one negotiated discount reduced the effective price by 3.5 percent.

Construction and Real Estate

Most reports suggest that California's real estate markets continue strong. Smaller California cities have not seen the 20 percent increases in home prices common in larger cities, but construction activity continues strong. However, relatively high interest rates reportedly have caused builders to become more cautious about committing to new projects. The limited supply of commercial buildings in the San Francisco Bay Area is causing values to escalate at about a 5 percent annual rate. In Southern California, a developer reports that commercial construction activity continues at a strong pace, although leasing activity has slowed during the past year. Most reports from Washington and Oregon indicate that real estate markets in the Northwest also are strong. Home prices are reported up, with strong construction activity as well. In contrast, reports from Arizona indicate that land values there continue to drop, and sales of commercial real estate are deeply discounted.

Financial Sector

Most western banks report strong profits, with solid loan demand despite relatively high interest rates. Some bankers report increased demand for commercial loans. Several bankers report reduced balances held in checking accounts, passbook savings, and money market deposit accounts. The combination of strong loan demand and reduced deposits is leading banks to raise rates on certificates of deposit in order to attract sufficient funds.

Only a few respondents report that high interest rates have limited borrowing activity. In Oregon, for example, small businesses reportedly are borrowing less or not at all, choosing to postpone capital equipment purchases or expensive acquisitions rather than pay the high rates.