Research Department
Federal Reserve
Bank of
San Francisco

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FRBSF Weekly Letter

Recession Year

The West always endures recessions better than the rest of the nation, or so the cliche goes. That cliche seemed somewhat battered in late 1981, however, as regional business activity weakened everywhere—from farms to factories to construction sites and government offices. Most observers forecast a continuation of the slump into early 1982, but then expect a turnaround generated by a boom in defense and certain other sectors—not to mention the stimulus arising from income-tax cuts and the recent drop in inflation and interest rates.

Activity in this nine-state region had been spotty during the earlier part of 1981, but in the fall months, production cutbacks and layoffs became widespread throughout the goods-producing sectors—manufacturing, mining and construction. Western farmers and ranchers experienced a second straight year of declining net income as a result of weakening commodity prices and rising production costs. Meanwhile, residential construction and home sales remained severely depressed, despite a late-year downturn in mortgage-loan rates.

Growing labor-market weakness

As a reflection of the late-1981 slump, employment increased only about one percent, on an annual-average basis, to about 16.4 million for the year. The increase in jobs was only about half as great as the 1980 increase, and only a fraction of the gains recorded during the boom of the late 1970s. And for a change, employment increased no faster in the West than in the rest of the nation (see chart). The only significant gains occurred in trade and services; indeed, those two industries accounted for practically all of the region's 400,000 employment increase of the past two years. Job prospects turned bleak in a number of manufacturing industries as the year advanced, while construction employment continued to decline on the heels of the 1980 slump. Reflecting the weakening of state-local government finances, job levels remained practically flat in the government sector for the fourth straight year, following several decades of steady growth.

Unemployment soared throughout the West, as employment stagnated and as more and more jobseekers poured into the regional labor force. For example, California's jobless rate practically matched the national jobless figure, which averaged 7.5 percent of the labor force for 1981 as a whole. Over the course of the year, unemployment rates rose several percentage points in most major Western states. Indeed, in the Pacific Northwest, jobless rates reached double-digit levels during the fall months because of the impact of the nationwide housing slump on the region's forest products industry.

Personal income rose about 11½ percent, to $435 billion for the year. This was slightly better than the gain elsewhere—yet somewhat below the region's 13-percent gain in 1980. Still, real incomes increased slightly, because consumer prices rose about 11 percent instead of at the soaring 16-percent pace recorded the previous year. (The improvement in the inflation picture may have been overstated, because of the way the volatile housing component skewed the consumer-price index, but some improvement nonetheless was evident.) Retail sales ran almost 10 percent ahead of the previous year's pace through the early fall months, thus outrunning the 1980 increase, but still failing to keep up with the pace of inflation. Moreover, the year-to-year gain in sales then narrowed toward yearend. Early signs pointed to a disappointing holiday season—as evidenced by the number of pre-Christmas clearance sales—and to a growing squeeze on retail profit margins.

Weak industrial performance

In the industrial sector, the key aerospace-equipment industry reduced its workforce about three percent over the course of the year because of a slowdown in orders for commercial products. Orders for commercial

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jet transports fell off sharply, reflecting the impact of declining passenger traffic and rising fuel costs on the earnings of the world's airlines. (As one consequence of this slowdown in orders, Lockheed announced plans to phase-out production of the wide-bodied L-1011 jet transport.) Civilian orders for electronic equipment also slowed as the national recession caused households and businesses to cut spending for such items as computers and communication equipment. Increased foreign competition added to the problems of California semiconductor firms, resulting in extended plant shutdowns during holiday weekend periods to work off excess inventory. In contrast, defense and space business increased sharply, as Congress substantially increased spending on such programs.

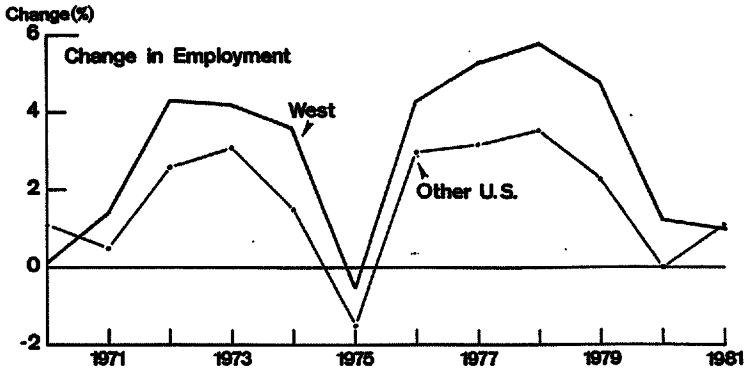
Western steel production rose about seven percent during the year, as the strong pace of nonresidential-building activity (especially an office-building boom) helped stimulate regional steel consumption. Western producers also managed to capture a larger share of the regional market, reducing the foreign-import share from 43 to 41 percent. The production gain followed on the heels of a 20-percent decline in 1980—when regional producers closed a number of high-cost facilities—so that industry output remained well below the 1979 peak. The Northwest's aluminum industry reopened some facilities shut down during a 1980 power shortage, but it eventually found itself with excess inventories because of the nationwide homebuilding slump and cutback in commercial-aircraft production. In this situation, the industry suffered a sharp profits squeeze, reflecting its inability to raise prices sufficiently to compensate for soaring energy and other costs. The copper industry meanwhile recovered somewhat from its 1980 strike, yet activity remained well below the 1979 peak due to weakness in demand from the auto, housing and appliance industries.

Regional petroleum consumption declined again during 1981, partly because of the recession, but also because of conservation measures induced by the Administration's decision to accelerate decontrol of domestic crude-oil prices. Western utilities and industrial plants reduced their demand for fuel oil, taking advantage of ample supplies of clean-burning natural gas—which because of price controls were also available at lower cost. Meanwhile, on the supply side, higher prices spurred a modest increase in regional crude production, on the heels of the sharp output gains of the 1976-80 period. But this time the boost came not from Alaska but from California, where higher heavy-oil prices triggered a wave of oil-recovery projects from older fields. The import share of the regional market continued dropping to 15 percent—from 48 percent at the 1976 peak—as Western refineries substituted more and more locally-produced oil for imports.

Depression in housing—and lumber

The three-year-old housing slump deepened further in 1981, with a 21-percent drop in building activity. Indeed, housing starts in the Western census region dropped to 243,000 units—the lowest for any year in the past generation. (At that level, starts were 56 percent below the 1978 average, compared with a decline of "only" 41 percent for the rest of the nation.) Home prices apparently fell in real terms, because of falling demand and the many "creative financing" schemes that builders and homeowners had to use to sell their properties. Most homes for sale remained out of the average family's reach, however, because of earlier price hikes and the early-1981 upsurge in mortgage interest rates, which exceeded 18 percent at the peak. During the year, the median-priced new home in California approached $108,000—about 50 percent higher than the median price elsewhere. At mid-1981 mortgage rates, a purchaser would have needed more than a $45,000 annual income to qualify for a mortgage loan on this average-priced California home.

The nationwide housing depression meant a deepening of the protracted slump in the Western lumber industry. With the cutback in



housing-related orders, and with declines in orders from the nonresidential-construction industry and the export trade, production fell to the lowest level of the past three decades. Softwood-lumber prices on average just about matched the 1980 average figure, partly reflecting the impact of a strike at British Columbia mills in the early part of the year—but the price trend was clearly downward, with prices at year-end off about 10 percent from late-1980 levels. The pulp-paper segment of the industry recorded modest gains in sales and employment during the first half of 1981, but it too later weakened under the impact of the national recession.

Squeeze on farm incomes

The combination of falling commodity prices and rising production costs meant a severe squeeze on the incomes of Western farmers and ranchers. Cash farm receipts increased eight percent, to about a $24-billion annual rate, for the first three quarters of the year. Yet bountiful supplies plus relatively weak export demand depressed prices for a wide range of products. And with production costs rising sharply, especially for credit and for energy-related inputs, net cash income apparently weakened for the year. This in turn meant a downtrend in sales for major supplier industries, such as farm-equipment dealers.

Wheat prices reached the lowest levels of the past three years, on the heels of another record crop. Still, farmers expect a price turnaround soon because of a rise in foreign and domestic demand, and hence a reduction in carryover. Wheat exports could be about one-fourth higher than last year's record, reflecting heavy demand from Russian, Chinese and Indian markets. In contrast to wheat, export demand for other products suffered because of the strengthening of the U.S. dollar. This led to rising inventories and lower farm prices for cotton, nuts and other crops heavily reliant on overseas sales. A special complicating factor in the crop picture was the medfly (Mediterranean fruit fly). California's $14-billion agricultural industry appeared threatened for a time by the medfly's infestation, but major commercial-crop growing areas remained safe from the insect's depredations. Still, the state incurred heavy expenses from the spraying of infected areas, and lost some sales in U.S. and foreign markets in the subsequent uproar.

Western cattle producers had a poor year, as their costs continued to rise while their prices fell under the impact of plentiful cattle supplies and weakening demand. Beef-cattle prices fell for the second straight year, and by late 1981 were about 14 percent below late-1979 quotations. Prices strengthened somewhat during the summer months, but then weakened again in the face of reduced consumer budgets and increased supplies of red meat and poultry. In response, cattlemen reduced their feedlot inventories this fall to the lowest levels of the past 15 years, and counted on slower marketings of fed cattle—and lower feed-grain prices—to restore their profit margins.

Brighter prospects for '82?

On balance, the 1981 performance of the Western economy was better than 1980's mediocre performance in one significant respect—higher real incomes—but worse in terms of the major employment and production indexes. After an unpromising start, 1982 should turn in a more respectable record. The new year begins with continuing growth in defense spending, energy exploration and commercial building. Residential builders and their supplying industries seem likely to start on the recovery path, partly because of a three-year backlog of pent-up demand, but mostly because of a turnaround in mortgage financing—evidenced by rising inflows of funds into lending institutions, lower mortgage and construction-loan rates, and hence sharp declines in the monthly payments of new homebuyers. Farm and nonfarm producers also should experience a better year as inventories get pared down to more reasonable levels. And Western consumers, like their counterparts elsewhere, should benefit from growing real incomes because of the package of tax stimuli now in place and (above all) because of the nation's continued progress against inflation.

William Burke and Yvonne Levy

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 12/9/81	Change from 12/2/81	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	155,206	383	8,902	6.1
Loans (gross, adjusted) — total#	134,122	185	10,048	8.1
Commercial and industrial	40,961	397	4,385	12.0
Real estate	55,488	58	5,356	10.7
Loans to individuals	23,388	53	− 646	− 2.7
Securities loans	2,274	218	920	67.9
U.S. Treasury securities*	5,802	186	− 949	− 14.1
Other securities*	15,282	12	− 193	− 1.2
Demand deposits — total#	41,049	− 2,295	− 5,613	− 12.0
Demand deposits — adjusted	29,498	566	− 4,835	− 14.1
Savings deposits — total	30,110	64	1,067	3.7
Time deposits — total#	88,039	843	17,733	25.2
Individuals, part. & corp.	79,470	800	18,376	30.1
(Large negotiable CD's)	34,777	789	7,047	25.4

Weekly Averages of Daily Figures	Week ended 12/7/81	Week ended 12/2/81	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	93	79	63
Borrowings	100	5	196
Net free reserves (+)/Net borrowed(−)	− 7	75	− 133

* Excludes trading account securities.
# Includes items not shown separately.

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