Research Department
Federal Reserve
Bank of
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Splintering Prices

Lumber prices, which defied governmental stabilization efforts during earlier phases of the price-control program, are less likely to pose a problem for Administration inflation fighters during the Phase IV period. Prices for key construction items were already dropping from record levels when the President imposed the 60-day freeze on June 13, and their continued decline has led the Cost of Living Council to exempt the lumber industry from wage and price controls under Phase IV. The welcome improvement in prices largely reflected a substantial decline in housing demand and a gradual disappearance of supply bottlenecks. Continued softening of the housing market should lead to further easing of lumber and plywood prices, despite occasional price flurries—such as occurred in late July and early August, when wholesalers and retailers sought to rebuild their depleted inventories.

The recent decline reversed an almost-uninterrupted 2½-year pattern of price increases, which made the lumber and wood-products category by far the fastest-rising category in the industrial price index. Between January 1971 and January 1973, wholesale prices of softwood lumber increased at a 28-percent annual rate, while the softwood-plywood index rose at a 24-percent rate, reflecting in part the incomplete coverage of the price-control program, which was geared mostly to final products and to large-firm operations. Throughout Phase II, there were no controls on raw timber prices, and during at least part of that period, there were no wage and price controls for the 62,000 small producers that dominate the industry.

The price advance accelerated under the quasi-voluntary Phase III program; between January and May, lumber prices rose at an 87-percent annual rate, while plywood prices shot upward at a 168-percent rate. In January, U.S. mills adjusted their prices to the free-market levels being charged by Canadian mills, and thereafter prices in both countries moved upward in tandem.

Why the spiral?

The spiral in lumber and plywood prices was induced by a sharp increase in demand imposed upon limited current supplies. The demand pressures stemmed from the increased requirements of the housing industry—the outlet for almost one-half of the entire domestic consumption of lumber and plywood. Housing starts jumped from 1.5 million units in 1970 to 2.5 million (annual rate) in January-February 1973, and lumber requirements went up accordingly.

In an effort to meet these heavy demands, domestic mills raised their softwood-lumber production over the entire 1971-72 period by 17 percent, to 32 billion board feet, and their plywood production 27 percent, to 18.5 billion square feet. Despite these record increases, production still lagged far behind

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the heavy inflow of orders. Unfilled orders for softwood lumber jumped one-third over the 1971-72 period, while stocks reached the lowest level since World War II. Lumber imports from Canada and other foreign sources filled only part of the gap, although rising from 6 to 9 billion board feet over the two-year period.

This unbalanced supply-demand situation was aggravated by the impact of the price-control program on a notably unconcentrated industry. Approximately 81,000 firms harvest, manufacture and market the various products of the industry, and less than 900 of them have annual sales of over $5 million. The largest producers (that is, those subject to controls) thus do not have a significant influence on prevailing market prices, so it is little wonder that attempts to maintain prices at artificially low levels not only created market distortions but also acted to discourage production.

Price controls and...

Ceiling prices for identical grades of lumber varied from mill to mill, and thus confronted buyers with different prices for the same item. In addition, specialty items carried higher ceiling prices than basic grades, causing producers to shift production to those lines, and thereby worsening the shortage of key construction items.

The profit-margin limitation provision of the Phase II program meanwhile tended to act as a production-limitation program; as large producers began to bump against their profit-margin limits in late 1972, they began to cut back, so that softwood-lumber output fell 9 percent below year-earlier levels. In this situation, according to certain buyers' allegations, some producers downgraded product quality, altered specifications to obtain premium prices on basic items, and sold products back and forth through various distribution channels to obtain inflated markups.

...production bottlenecks

Domestic mills were hampered in raising production by the soaring costs and limited supplies of their basic raw material, logs. Prices of stumpage from the National Forests of Western Washington and Oregon more than doubled over the 1971-72 period, with about half of that increase occuring in the second half of 1972 alone. (These and other National Forests provide about 27 percent of the nation's softwood-timber harvest.) Shortages developed in this period mostly because budgetary cutbacks, manpower shortages and environmental controversies prevented the Forest Service from preparing much of its allowable cut for sale. Thus, sales of public sawtimber declined from 11.7 to 8.8 billion board feet between fiscal 1970 and fiscal 1973.

To aggravate the situation, an increasing volume of unprocessed logs was exported overseas, mainly to Japan. Exports of softwood logs reached a record 3 billion board feet in 1972—about 14 percent above the earlier (1970) peak. In Washington and Oregon, the source of the vast bulk of this trade, exports rose to about 17 percent of the entire log supply. (A decade earlier, the Northwest's export trade in logs had been virtually nil.) Smaller, non-integrated producers, who do not own their own stands of timber and thus must rely on logs from Federal lands, were vocal in their criticism of this trade, claiming that it permitted them only limited supplies at astronomical prices.

Turnaround

Market conditions eased this spring and summer, as housing demand declined and lumber supplies increased, and price declines in some cases were nothing short of spectacular. Between the early April peak and early August, the price of Douglas fir 2 by 4's dropped 16 percent, while the price of quarter-inch interior-grade sanded plywood plummeted 44 percent.

On the demand side, housing starts dropped 16 percent between January and June of this year. The decline was attributed to rising mortgage costs as well as earlier overbuilding by some contractors, and in addition to sharp increases in construction costs. (Between last summer and this spring's peak, the increase in lumber and plywood prices alone added almost $1,500 to the cost of the average house.) Meanwhile, under Administration pressure, Japanese buyers agreed to reduce their softwood log imports in the current half-year by 15 percent from the comparable period of 1972.

On the supply side, lumber mills boosted their production to full capacity, confident that increased supplies of Federal timber would be forthcoming. To implement this, the Administration developed plans to boost Federal timber sales 18 percent this year, and to assure even higher levels of available supplies in the next two years.

Lumber and plywood prices may well continue to decline, especially in view of the projected drop in housing starts over the next year or so. But what happens when housing demand rebounds, as it undoubtedly will later in the decade? According to the latest Forest Service appraisal of the outlook, "Demands and supplies of softwood sawtimber can be expected to balance in the future only with rather substantial increases in prices of lumber and other wood products relative to other materials."

This source suggests that demand for industrial wood will rise at least 60 percent by the turn of the century, but that with current levels of forest management, only modest increases in timber supplies will be available. Indeed, the most serious prospective shortfall will involve the larger sizes of softwood now utilized in home construction.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 8/8/73	Change from 8/1/73	Change from year ago Dollar	Percent
Loans adjusted and investments *	75,087	+ 1,089	+ 11,510	+ 18.10
Loans adjusted—total*	58,276	+ 1,128	+ 11,756	+ 25.27
Commercial and industrial	20,319	+ 63	+ 3,626	+ 21.72
Real estate	16,849	+ 22	+ 2,858	+ 20.43
Consumer instalment	8,508	+ 16	+ 1,334	+ 18.59
U.S. Treasury securities	5,141	− 78	− 983	− 16.05
Other securities	11,670	+ 39	+ 737	+ 6.74
Deposits (less cash items)—total*	71,380	− 409	+ 8,585	+ 13.67
Demand deposits adjusted	21,317	+ 3	+ 1,505	+ 7.60
U.S. Government deposits	301	− 296	− 377	− 55.60
Time deposits—total*	48,572	+ 207	+ 7,341	+ 17.80
Savings	17,692	− 86	− 509	− 2.80
Other time I.P.C.	22,020	+ 389	+ 6,122	+ 38.51
State and political subdivisions	6,057	− 124	+ 808	+ 15.39
(Large negotiable CD's)	11,286	+ 466	+ 5,726	+ 102.99

Weekly Averages of Daily Figures	Week ended 8/8/73	Week ended 8/1/73	Comparable year-ago period
Member Bank Reserve Position			
Excess reserves	+ 20	71	34
Borrowings	239	199	6
Net free (+) / Net borrowed (−)	− 219	− 128	+ 28
Federal Funds—Seven Large Banks			
Interbank Federal funds transactions			
Net purchases (+) / Net sales (−)	+ 109	+ 167	−1,001
Transactions: U.S. securities dealers			
Net loans (+) / Net borrowings (−)	+ 267	− 75	− 324

*Includes items not shown separately.

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