Research Department
Federal Reserve
Bank of
San Francisco
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Commodity Crunch

The nation's basic materials industries have been operating nearer full capacity this year than at any other time since World War II. Production of these materials—including petroleum, steel, nonferrous metals, wood products, and textiles—reached 96.3 percent of capacity during the third quarter. Yet the worldwide demand for these commodities has been so strong that many are still in short supply. As if this were not enough, the Middle East war and the associated Arab oil embargo have now aggravated the supply problems for a nation whose economic life is centered around the internal-combustion engine. Many respondents to the monthly survey of the National Association of Purchasing Management no longer bother to list specific shortages, but simply report that "almost everything" is in short supply.

Prices for industrial commodities have reflected these upward pressures, although their movements in the last two months have been obscured somewhat by sharp declines in farm-and-food prices from recent spectacular highs and by a consequent decline in the overall wholesale price index. Industrial commodity prices rose at a 10.6-percent annual rate between August and October, fully as worrisome as the 10.2-percent and 14.9-percent annual increases recorded in the first and second quarters of the year.

Oil shortages

The August-October rise in the industrial commodity index was dominated by a 38.7-percent annual rate of increase in crude material prices—petroleum in particular. Further price advances in the overall index appear all but inevitable in coming months, in view of the Arab oil embargo and the sharp price increases imposed by other major oil exporting nations.

These moves will affect both the price of petroleum products and the price of products which require petroleum as a basic raw material, such as chemicals, fertilizers, plastics and synthetic fibers. In addition, fuel shortages may indirectly contribute to inflationary pressures by aggravating the shortages of other basic materials, such as steel and aluminum, that require large quantities of fuel oil and natural gas for their production.

Shortly after the Arab nations raised their crude-oil prices, other major oil exporters (such as Nigeria, Venezuela and Indonesia) also announced substantial increases. Some countries raised selling prices by more than 50 percent and listed even sharper advances in "posted" prices—prices on which taxes are based. To enable domestic producers and retailers to pass on these higher import costs on a dollar-for-dollar basis, the Cost of Living Council in late October lifted its price freeze on oil products and permitted the industry to boost prices accordingly once a month. The major oil companies responded by raising their prices for gasoline, heating oil and diesel fuel by as much as three cents a gallon at both wholesale and retail—the largest single increases ever recorded.

(continued on page 2)

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Prior to the outbreak of the Mideast war, the U.S. had been importing about 6 million barrels of crude oil and refined products daily. The oil embargo and related cutbacks in Arab petroleum shipments to other nations have cut off about 2 million barrels a day, or roughly 10 percent of present U.S. consumption. As petroleum demand increases during the winter, the overall shortfall may approach 3-million barrels, or about 17 percent of normal demand.

Fuel shortages already are having an inflationary impact on the prices of several basic materials. The shortage of fuels (and glues) has sent plywood prices soaring about 40 percent since mid-October— that's not an annual rate—reversing a slide from record levels that began in May in the wake of the housing slowdown. The recent spurt occurred after six Oregon plywood mills closed due to a shortage of natural gas and propane, triggering a wave of scare buying. Prices of nitrogen and phosphate fertilizer, which use natural gas as a raw material, jumped 30 percent after fertilizer price controls were lifted.

Metals shortages

Many basic materials, especially nonferrous metals, already were in very short supply even before the Mideast war broke out last month. (At that point, nonferrous metal prices were 19.9 percent higher than a year before.) This situation was aggravated by a price-control mechanism which held domestic prices well below foreign prices, thereby causing metal to be diverted to markets overseas.

Earlier this year, the U.S. became a net exporter of copper, reversing a net-import position which had prevailed since 1940. The Mideast conflict, together with worldwide production problems, then triggered a wave of speculative buying, which helped widen the price differential and stimulated exports even more. By mid-November, copper on the London Metal Exchange reached $1.05 per pound, compared with the 60-cent U.S. producer price.

The shortage of zinc has become very severe, mostly as a result of the diversion of supplies overseas. Several major steel producers consequently have announced sharp reductions in production of galvanized sheet, and Kaiser Steel is considering going out of the galvanized sheet business altogether on the West Coast.

The domestic aluminum industry has relied on government stockpile metal to meet 20 percent of its customers' total requirements, because of very strong demand and hydro-power shortages. However, producers no longer can count on that source, since all of the 1.3 million tons available from the stockpile already has been purchased.

The demand pressures impinging on the metals industries could ease somewhat next year, if activity should slow in key consuming sectors such as housing and automobiles. But the Mideast conflict has introduced a new inflationary force which could help offset their im-

Business & Financial Letter

pact. To replace war material furnished to Israel and to build up our own defenses, the Pentagon is now submitting perhaps $5-6 billion in several supplemental budget requests. Authorization by Congress of even a portion of these expenditures could give defense procurement—and the aerospace industry's use of metals—a strong upward thrust.

How to allocate

In any event, the immediate shortage of fuels now confronting the nation requires that consumption be tailored to fit available supplies. This may be achieved by imposing a system of physical allocations or by permitting the price system to do the necessary rationing—or by a combination of both approaches. In the case of the distillates—heating oils, diesel and jet fuels—the government has been utilizing the mandatory-allocation approach since November 1. The program, as later modified by the President, directs the oil companies to pare allotments to wholesalers to 85 percent of the 1972 level—a move which is forcing the nation's airlines to cut scheduled flights 10 percent.

In this connection, Congress has passed legislation which would extend the mandatory-allocation program to all crude oil and refined products produced in the United States. In his message on the fuel crisis, the President also prohibited coal-using utilities from converting to oil, and ordered Federal agencies to turn down their thermostats and to reduce their auto speeds to 50 miles per hour—moves he recommended the private sector follow.

In addition, the President asked Congress for stand-by authority to order a wide range of conservation measures. These include relaxing certain environmental regulations, imposing daylight-saving time on a year-round basis, and adjusting operating schedules for businesses and airlines. Finally, as a last resort, the President said that contingency plans would be developed to be used if necessary "to cut the consumption of oil products such as gasoline by rationing or by a fair system of taxation." (These and other measures are embodied in the National Emergency Petroleum Act now before Congress.)

Interior Secretary Morton said that rationing probably would have to be imposed within the next several months. Treasury Secretary Shultz disputed this, however, and his staff reportedly is working on such possibilities as a stiff increase in the Federal gas tax from the present 4 cents to as high as 30 cents a gallon.

Milton Friedman, in his **Newsweek** column, meanwhile proposed the radical solution of relying completely on the marketplace, by permitting fuel prices to rise as high as necessary to reduce demand. Prices would rise sharply in the short-run if the price mechanism (or taxes) were used to allocate fuel supplies, but over the long-run these price increases would stimulate increased production rather than create supply disruptions.

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 11/7/73	Change from 10/31/73	Change from year ago Dollar	Change from year ago Percent
Loans adjusted and investments*	75,836	+ 484	+10,339	+ 15.79
Loans adjusted—total*	57,778	− 48	+ 9,398	+ 19.43
Securities loans	1,298	+ 141	0	0.0
Commercial and industrial	19,810	− 60	+ 2,461	+ 14.19
Real estate	17,825	+ 37	+ 3,139	+ 21.37
Consumer instalment	8,844	+ 1	+ 1,342	+ 17.89
U.S. Treasury securities	5,648	+ 227	− 306	− 5.14
Other securities	12,410	+ 305	+ 1,247	+ 11.17
Deposits (less cash items)—total*	73,511	− 169	+ 8,769	+ 13.54
Demand deposits adjusted	22,708	+ 393	+ 1,682	+ 8.00
U.S. Government deposits	455	− 228	− 126	− 21.69
Time deposits—total*	49,050	− 349	+ 7,109	+ 16.95
Savings	17,494	+ 9	− 827	+ 4.51
Other time I.P.C.	22,553	− 181	+ 5,736	+ 34.11
State and political subdivisions	5,748	− 131	+ 1,043	+ 22.18
(Large negotiable CD's)	11,167	− 15	+ 4,942	+ 79.39

Weekly Averages of Daily Figures	Week ended 11/7/73	Week ended 10/31/73	Comparable year-ago period
Member Bank Reserve Position			
Excess reserves	51	35	11
Borrowings	11	90	100
Net free (+) / Net borrowed (—)	40	− 55	− 89
Federal Funds—Seven Large Banks			
Interbank Federal funds transactions Net purchases (+) / Net sales (—)	−199	−303	−1,130
Transactions: U.S. securities dealers Net loans (+) / Net borrowings (—)	+106	+ 83	− 146

*Includes items not shown separately.

Information on this and other publications can be obtained by calling or writing the Administrative Services Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco, California 94120. Phone (415) 397-1137.