Research Department
Federal Reserve
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Commodity Slump

Commodity prices have declined on a broad front in the past half-year, reflecting the impact of the worldwide recession on the demand for farm products and industrial raw materials. The Bureau of Labor Statistics' index of commodity prices, which measures spot price movements of two dozen internationally-traded commodities, now stands about 20 percent below last July's peak. Prices of some components have recently shown signs of stability, but the general trend still appears to be downward.

The broad-based decline in primary commodity prices has worked to hold down prices for processed food and industrial goods at later stages of the production process, as evidenced by the steady decline since last winter in the overall wholesale-price index. The consumer-price index continues to rise because of the pressure of rising middlemen's costs, but the rate of increase has slowed to about one-half of the late-1974 pace.

Commodity inflation

This slump marks an abrupt end to the pervasive 1972-74 inflation in commodity markets. The quadrupling of crude-oil prices in the winter period a year ago was the most dramatic indication of this price upsurge, but there were many other sharp increases posted during this two-year time-span. In fact, the BLS commodity index which—does not include petroleum—nearly doubled between mid-1972 and mid-1974. The only comparable episode during the past generation was the commodity "crunch" at the onset of the Korean War, and that upsurge was followed by a weakening trend that lasted for at least a decade and a half.

The recent price surge was attributable to a worldwide economic boom that boosted the demand for both farm products and industrial raw materials. For the first time in two decades, the economies of most industrial nations moved together in the expansion phase of the business cycle. This synchronized boom stimulated employment and output, but at the same time it strained the capacity of many basic industries, creating shortages and upward pressures on prices. Indeed, by the third quarter of 1973, U.S. production of such basic materials as petroleum, steel, nonferrous metals, forest products and textiles reached 96.3 percent of capacity, the highest since World War II.

Meanwhile, strong worldwide demand for reduced supplies of farm products created a price

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spiral in a sector which had experienced relative stability throughout most of the two preceding decades. The food- and feed-grain situation stabilized temporarily in late 1973 because of the expectation of bumper crops and a recession slowdown in demand, but as weather disasters destroyed crop hopes, prices headed upward again until the fall of 1974. Similarly, poor growing weather in the tropics helped boost prices for the world's coffee, cocoa and sugar crops.

As for nonferrous metals, processing capacity during this period proved inadequate to meet the sudden surge in worldwide demand. New capacity had failed to come on stream in adequate amounts, reflecting such factors as a prolonged downtrend in the rate of return on investment in earlier years. In addition, a growing share of the available new investment had gone into (nonproducing) pollution-control equipment.

Final push

The Arab oil embargo during the winter of 1973-74 provided a final push to an already frenzied market. By aggravating the overall inflation, undermining many national currencies and creating a general fear of shortages, the embargo touched off a wave of speculative buying that pushed industrial commodity prices to new heights. But then, as the embargo ended and the worldwide recession deepened, a speculative sell-off and consequent decline in raw-material prices was all but inevitable.

Normally, commodity prices act as a leading indicator, turning downward before the onset of recession. That failed to happen this time. The hoarding sparked by the oil embargo postponed the price decline for raw industrial materials until April 1974, several months after the U.S. economy registered its first decline in physical output. For most foodstuffs—and for the overall index—the turn didn't come until much later. Livestock prices peaked in early 1974 as the rising cost of feed forced ranchers to liquidate herds and reduce feeding operations, but it wasn't until late fall that prices began to tumble in the markets for grains, sugar, cocoa, and fats and oils. Once the decline began, however, prices fell with great momentum, so that the overall index now stands 20 percent below last summer's peak.

Continued weakness

The near-term outlook is for continued weakness in commodity prices, at least until a turnaround occurs in economic activity. In nonferrous metals

industries, producers have attempted to stabilize prices by cutting back production, but their efforts have been largely unsuccessful because of the weakness of demand from the housing, auto and appliance industries, and also because of the excessive level of inventories throughout the world. In the food industry, prices could recede further if this year's crops come up to expectations, although heavy inventories (and therefore downward price pressures) are lacking in many sectors; for example, world grain stocks are now at the lowest level of the past two decades.

While the immediate problem of shortages has been overcome, the question arises whether the world will be confronted in future decades with chronic and persistent shortages of minerals, food and other primary commodities. The answer is probably no, according to a Brookings Institute panel of 15 experts from the European Community, Japan and North America. Relative prices of primary products might very well rise over the long-run because of the growth of world demand, increased environmental costs, and the necessity to utilize lower-quality land and mineral resources. However, the Brookings group does not believe in the inevitability of this course, principally because technological change will continue to offset many of these cost pressures. Moreover, the experts doubt the ability of non-oil producer cartels to dictate prices and control supplies, partly because of the widespread incidence of primary commodities throughout the world, and partly because of the effect of artificially high prices in spurring conservation and encouraging the development of substitute materials and new sources of supply.

At the same time, the Brookings panel argues that several requirements must be met to assure adequate supplies at relatively stable prices. In its view, producers must be assured of an adequate rate of return on investment to encourage the development of resources and necessary processing capacity. In that regard, producers and consumers may find it worthwhile to cooperate in the creation of buffer stocks, in order to stabilize prices in the face of shifting supply-and-demand developments. As an additional incentive to investment, the panel suggests the development of international rules—by the World Bank, for example—that would govern sensitive issues such as ownership rights and taxes in a manner mutually acceptable to host governments as well as foreign investors.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 4/9/75	Change from 4/2/75	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	85,871	+ 460	+ 4,131	+ 5.05
Loans (gross, adjusted)—total	65,747	+ 354	+ 3,209	+ 5.13
Security loans	1,984	+ 192	+ 1,022	+ 106.24
Commercial and industrial	24,304	+ 209	+ 1,666	+ 7.36
Real estate	19,595	– 13	+ 808	+ 4.30
Consumer instalment	9,787	– 13	+ 581	+ 6.31
U.S. Treasury securities	7,541	+ 4	+ 1,595	+ 26.82
Other securities	12,583	+ 102	– 673	– 5.08
Deposits (less cash items)—total*	85,139	+ 501	+ 6,584	+ 8.38
Demand deposits (adjusted)	24,240	+ 920	+ 621	+ 2.63
U.S. Government deposits	196	– 70	– 169	– 46.30
Time deposits—total*	59,347	– 190	+ 6,297	+ 11.87
States and political subdivisions	6,565	+ 21	– 21	– .32
Savings deposits	19,540	+ 46	+ 1,387	+ 7.64
Other time deposits‡	29,593	– 237	+ 3,898	+ 15.17
Large negotiable CD's	16,405	– 153	+ 3,614	+ 28.25

Weekly Averages of Daily Figures	Week ended 4/9/75	Week ended 4/2/75	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves	24	70	75
Borrowings	0	0	22
Net free (+) / Net borrowed (–)	+ 24	+ 70	+ 53
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+) / Net sales (–)	+ 2,107	+ 1,740	+ 1,625
Transactions of U.S. security dealers			
Net loans (+) / Net borrowings (–)	+ 1,184	+ 715	+ 77

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

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