

Research Department
Federal Reserve
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Timber!

Lumber prices, after spiralling upward throughout most of the last four years, are finally showing some signs of weakness. Softwood-lumber prices in general turned down in January, and Douglas-fir prices dropped for the second month in a row. Softwood-plywood prices moved against this trend in January, but only to the extent of offsetting a steep December decline.

The recent softness reflects the uncertain outlook for housing. Wholesalers have been holding off their orders for spring delivery, waiting to see whether the recent slowdown in homebuilding is merely weather-related or whether homebuilding has begun to enter a long-predicted period of cyclical decline. Both producers and wholesalers are worried that their industry will go through a repeat of the dismal 1973-75 experience. When housing slumped during that period, U.S. softwood lumber consumption dropped at a 10-percent average annual rate.

A closer examination of the fundamentals underlying housing and other key markets suggests, however, that any decline in lumber consumption this year will be relatively mild. Moreover, production could be restricted by the high cost and limited availability of timber, mitigating any downward price pressures from the supply side. Thus, any decline in prices should be quite moderate, and yearly-average prices could just about match 1978's peak levels.

The recent softness comes on the heels of an almost uninterrupted 4-year pat-

tern of price increases, which made the lumber and wood-products category by far the fastest-rising major component in the industrial price index. Between November 1974 and November 1978, wholesale prices of softwood lumber increased at a 26-percent annual rate, while the plywood index rose at a similar pace.

Demand, supply strains

The upsurge in lumber and plywood prices was induced by a sharp cyclical expansion in demand imposed upon a limited increase in supply. The demand pressures stemmed primarily from the increased requirements of the housing industry — the outlet for almost one-half of the entire domestic consumption of softwood lumber and plywood. Housing starts rose steadily from 1.2 million units in 1975 to 2.0 million units in 1978, pushing up lumber requirements accordingly. Meanwhile, the volume of lumber required in other uses — repair and remodeling, non-residential construction and materials handling — also boosted demand, but to a lesser extent.

In an effort to meet these heavy demands, domestic mills raised their softwood lumber production over the 1975-78 period by 16 percent (to 31 billion board feet) and their plywood production 19 percent (to a record 18.7 billion square feet). But consumption rose even more rapidly, so that wholesalers were forced to turn increasingly to foreign mills to meet their customers' requirements. As a result, the volume of lumber imported from Canada and other foreign sources rose from 14 to 25 percent of total U.S. softwood-plywood consumption over the 1975-78 period.

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Domestic production was hampered by the soaring costs and limited supplies of the industry's basic raw material, timber. While housing starts rose 73 percent over the 1975-78 period, sales of timber from the National Forests in Washington and Oregon showed little overall increase. In fact, sales actually declined from 11 to 9 billion board feet over the fiscal 1975-77 period before regaining the original level again in fiscal 1978. Consequently, stumpage prices on those forests nearly doubled over the three-year period, with a 27-percent average annual increase.

Timber problems

The unresponsiveness of National Forest timber offerings to market conditions reflects in part the "sustained-yield" model followed by the U.S. Forest Service and other agencies in determining the potential harvest on public lands. Their essentially biological approach limits the potential harvest — what used to be called the annual allowable cut — to a quantity that can be removed from the forest in perpetuity on a sustained-yield basis. Sustained-yield connotes perpetual maintenance of the productive capacity of the forest without reference to variations in harvest within or among decades. But the Forest Service has defined it as basically a non-declining even-flow policy in which potential yield or harvest is assumed virtually constant for a ten-year period.

The key aspect of this supply function is its unresponsiveness to bid prices, since it is determined on the basis of biological factors which are independent of any cost considerations. When demand shifts upward, the full impact is exerted on price. To further aggravate the price pressures, the actual volume available

for sale from a given forest may be even lower than the potential if the agency concerned does not receive sufficient governmental appropriations to administer that volume of sales. Furthermore, the set-aside of productive forestland for wilderness use (or study for possible wilderness designation) reduces the amount of timber available for sale, because it removes productive forest land for inclusion in the harvest-determination process. The Roadless Area Review and Evaluation Process (RARE II) thus has adversely affected National Forest timber sales.

Prices in 1979?

This year, U.S. lumber and plywood consumption are likely to decline as a result of the expected drop in housing starts. But despite the many similarities between the current period and the last housing peak in early 1973 — including double-digit inflation in home prices and mortgage interest rates — there is little reason to expect a repetition of that earlier period's subsequent steep and prolonged contraction in homebuilding. On the contrary, most analysts expect housing starts to drop from a yearly total of just over 2.0 million in 1978 to about 1.7 million in 1979 and then to turn upward again in 1980. This amounts to a one-year decline of 15 percent — nothing like the three-year decline during the 1973-75 period when housing starts dropped at an average annual rate of 17 percent.

There are several factors that suggest that any forthcoming housing decline will be relatively mild and short-lived. Demand is likely to be supported by the high rate of household formations (resulting from the very large number of 24-34 year olds), by the trend toward two-income households, and by the

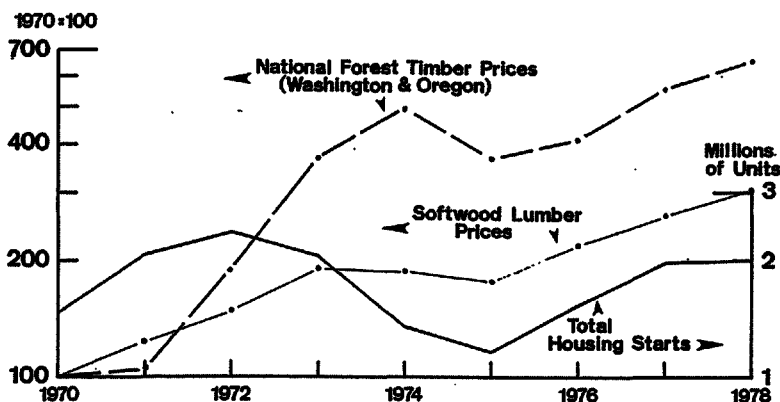
prevalent belief that home ownership is still the single best hedge against inflation. On the supply side, there is much less chance of a "credit crunch" — i.e., a drying up of mortgage and construction money — now that savings institutions are able to issue new instruments that permit them to compete for deposits in an environment of high interest rates. (For example, deposits are continuing to flow into the new six-month savings certificates with interest rates tied to Treasury bills.) The higher cost of credit for builders and borrowers is bound to affect the pace of homebuilding, but certainly not to the extent experienced in past credit crunches.

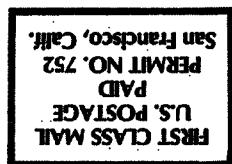
Growing expenditures for residential repair and remodeling should help moderate the impact of this year's expected homebuilding slowdown on the lumber industry. These expenditures rose sharply in 1978, and may continue to do so in 1979, as many homeowners decide to improve what they have instead of trying to meet the very high costs of new construction. Nonresidential construction, at least in certain sectors, also should help offset the impact of the decline in homebuilding.

Based on these developments and some further modest growth in lumber's other markets — such as furniture, containers and other consumer goods — U.S. softwood lumber consumption may decline only about 4 percent this year to about 39 billion board feet. (Consumption of softwood plywood may show an even smaller decline, because historically it tends to outpace the softwood-lumber market.) Timber shortages should be less of a problem in that environment, and domestic mills thus should be able to supply an increased proportion of the nation's total softwood-lumber consumption.

All of these factors on the demand side, as well as the continuation of relatively strong timber-cost pressures, should act to prevent anything but a modest decline in the average level of lumber prices this year. Moreover, once housing demand rebounds, consumers could face another resurgence in lumber prices due in part to supply problems resulting from restrictions on harvests in the National Forests.

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 2/7/79	Change from 1/31/79	Change from year ago @	
			Dollar	Percent
Loans (gross, adjusted) and investments*	120,465	+ 90	NA	NA
Loans (gross, adjusted) — total#	98,336	+ 17		
Commercial and industrial	28,989	+ 162		
Real estate	35,092	+ 108		
Loans to individuals	20,223	+ 11		
Securities loans	1,647	+ 12		
U.S. Treasury securities*	7,590	+ 32		
Other securities*	14,539	+ 41		
Demand deposits — total#	39,641	- 733		
Demand deposits — adjusted	29,312	- 82		
Savings deposits — total	29,702	+ 29		
Time deposits — total#	50,777	- 229		
Individuals, part. & corp.	41,286	- 84		
(Large negotiable CD's)	18,765	- 209		
Weekly Averages of Daily Figures	Week ended 2/7/79	Week ended 1/31/79	Comparable year-ago period	
Member Bank Reserve Position				
Excess Reserves (+)/Deficiency (-)	+ 20	- 77	-	99
Borrowings	27	56		161
Net free reserves (+)/Net borrowed(-)	- 7	+ 21	-	62
Federal Funds — Seven Large Banks				
Net interbank transactions	+ 881	+ 1,363	+ 1,852	
[Purchases (+)/Sales (-)]				
Net, U.S. Securities dealer transactions	+ 346	+ 616	+ 291	
[Loans (+)/Borrowings (-)]				

* Excludes trading account securities.

Includes items not shown separately.

@ Historical data are not strictly comparable due to changes in the reporting panel; however, adjustments have been applied to 1978 data to remove as much as possible the effects of the changes in coverage. In addition, for some items, historical data are not available due to definitional changes.

Editorial comments may be addressed to the editor (William Burke) or to the author

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