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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

May 17, 1974

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Arthur L. Broida

Enclosed for your information is a copy of a report by Governor Brimmer entitled "Eleventh Meeting of Governors of Central Banks of the Western Hemisphere", and a copy of the paper Governor Brimmer presented at the meeting.

Enclosures

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FEDERAL RESERVE SYSTEM

Office Correspondence

Date May 13, 1974

To Board of Governors

From Andrew F. Brimmer

Subject: Eleventh Meeting of Governors of Central Banks of the Western Hemisphere.

The eleventh annual meeting of Governors of Central Banks of the Western Hemisphere was held in Caracas, Venezuela, April 29-30, 1974. It was followed by a meeting of the Assembly of the Center for Latin American Monetary Studies (CEMLA) and by the eighteenth meeting of Governors of the Latin American Central Banks. An account of the CEMLA Assembly and of the Latin American meeting is presented in Appendix A.

Twenty six central banks were represented at the hemispheric meeting, sixteen of them by their President or other chief executive officer. In addition, Panama, where there is no central bank, was represented by the Chairman of the National Banking Commission, who is also Minister of Finance and Economic Planning. The Federal Reserve delegation, which I headed, included Presidents Hayes and Kimbrel, of the Federal Reserve Banks of New York and Atlanta, respectively, Mr. Pardee, Vice President of the Federal Reserve Bank of New York, and Mr. Maroni, Senior Economist in the Board's Division of International Finance.[1/]

Three topics were on the agenda of the meeting: (1) central bank mechanisms to channel credit; (2) the recent experience with floating exchange rates; and (3) the impact of the world demand-supply situation for petroleum on the economies and balances of payments of the countries of the Western Hemisphere. For each topic, there was a formal paper, followed by two prepared comments. The floor was then open for a general discussion. It was my responsibility to present the main paper on the petroleum problem. A copy of my paper is attached.

1/ This report is largely based on Mr. Maroni's notes.

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In general, the discussions were useful and interesting. The participants were frank in sharing their experiences, though I sensed a definite reluctance to speak on the petroleum question on the part of many of the representatives from countries entirely dependent on imports for their petroleum supplies. It appears that they were afraid to ruffle the feelings of the petroleum exporting countries of the region -- and particularly those of the host country, Venezuela -- if they drew attention to the harm which is being done to them by the higher price of petroleum. It is likely that the petroleum importing countries of the region are counting heavily on the goodwill of their more fortunate neighbors to induce the latter to recycle a portion of their surplus petroleum earnings directly or indirectly to them, thereby alleviating their difficulties. The petroleum importing countries of the region may also be unwilling to speak up on the impact of the higher petroleum prices because they hope to be able, some day, to raise the prices of their own exports.

The Petroleum Problem

The presentation which I made on the petroleum question was well received. Several of the participants said that they were glad that the question was being discussed unemotionally and purely from the point of view of the financial and economic realities which a higher price of petroleum entails -- whatever its precise level. Some of the participants told me privately outside the meeting room that they were pleased that an impartial analysis of the facts had been presented by our delegation, since this was not a very popular approach to the question in the region. President Hayes

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made a useful contribution to our presentation by amplifying and making more explicit my prepared remarks on some of the financial strains likely to arise in the markets as the surplus earnings of the petroleum exporting countries are recycled, and this too was favorably commented on by the participants. A detailed account of the comments made by the participants on the petroleum problem is presented in Appendix B.

Floating Exchange Rates

The main paper on floating exchange rates was presented by the Bank of Canada, which was represented by Mr. Robert Johnstone, Adviser. Mr. Johnstone contended that the fears expressed before 1973 by the critics of a move to floating exchange rates have not been realized. He noted that international trade had not been disrupted and instead had continued to grow in 1973, that the fluctuations in exchange rates which have occurred since the beginning of 1973 were by and large in appropriate directions and helped to redress the persistent imbalance in the payments position of major countries rather than being perverse as some feared, and that the adoption of floating rates had not been accompanied by attempts to escape from the responsibility of cooperating in seeking solutions to international monetary and payments problems or to escape from a disciplined management of domestic policies. He conceded that one year was too short a period to reach definitive conclusions and that the story might have been different if many countries had been faced with problems of faltering demand and unemployment instead of unusual strength in demand. But as things turned out, he felt that floating, on the whole, had worked well. He gave

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a favorable account of Canada's experience with floating rates since 1970. While he warned that this was not necessarily applicable to other countries and that he was not preaching the merits of floating rates for all countries at all times, his own preference for such a policy -- not unexpectedly -- was unmistakable.

The prepared comments were made by the representatives of Uruguay and Jamaica, who took issue with the main Canadian contention. Both said that the trade expansion of 1973 was motivated by boom conditions which were so strong that they could not have been outweighed by uncertainties generated by floating rates. The Uruguayan representative also pointed out that the move to floating rates reflected a lack of monetary discipline and that the will to negotiate a comprehensive reform of the international monetary system had waned in recent months. The Jamaican representative expressed the view that the magnitude of the exchange rate movements in 1973 was, at times, questionable and in some cases in the wrong direction. He noted that the conditions of 1973 required anti-inflationary policies and that this more than offset any temptation to relax internal financial discipline that floating might otherwise have fostered.

The representatives of Uruguay and Jamaica assessed floating rates primarily from the standpoint of the developing countries. Not surprisingly, they expressed unhappiness with the present arrangements and stressed the problems and difficulties which these arrangements are causing them. Among the problems cited were the lack of a forward market in the developing countries, the instability of exchange rates between the

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currencies of neighboring developing countries which use different intervention currencies (e.g. Jamaica is tied to the dollar while the other commonwealth Caribbean countries continue to be tied to sterling), the variability of the real value of reserves and of export earnings, the complications arising for a developing country whose currency is pegged to a floating intervention currency because its exchange rate vis-à-vis other currencies moves without regard for the state of its own balance of payments, and the reduced need to create SDRs because the currencies of the major countries are floating, at a time when the developing countries need more liquidity rather than less because their currencies are pegged to floating intervention currencies.

In the ensuing discussion, Mr. Cano, President of the Central Bank of Chile, expressed a preference for frequent rate adjustments for countries experiencing chronic inflation; Mr. Barreto, President of the Central Bank of Peru, pointed out how difficult it was to tell whether floating intensified an internal disequilibrium or resulted from it; and Mr. Uribe, the Bank of Mexico's Manager for Economic Policy and Research, explained that the fixity of the peso-dollar rate was a cardinal element of policy which the Mexican authorities had decided not to alter in 1973 in the belief that other means could be used to deal with the problem.

I commented that the world was really on a mixed system of fixed and floating rates and that floating was subject to various degrees of intervention. I spoke briefly about U.S. intervention, and President Hayes amplified my remarks on this point. I noted that the depreciation of the dollar in the March-July 1973 period had added substantially to domestic

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inflationary pressures and that the need to coordinate monetary policies among countries was not diminished by floating.

I emphasized that, while the U.S. money markets were more open now than they had ever been, following the elimination of capital controls, it should not be concluded that the U.S. authorities would allow their influence over domestic interest rates to be diminished.

The discussion made it clear that the developing countries would prefer a greater degree of stability among major currencies than has prevailed in the last twelve or fifteen months. The Uruguayan delegate in particular spoke of the need for intervention in exchange markets and urged the prompt adoption of guidelines for this purpose. However, there appeared to be a general recognition that an improved adjustment process among the industrialized countries would be beneficial to the developing countries and a readiness to put up with some of the inconveniences of floating if this would help to establish conditions under which the transfer of real resources from the developed countries to the developing countries would not be jeopardized every time that a balance of payments adjustment is needed by the former.

The Transfer of Real Resources

Indeed, the transfer of real resources to the developing countries appeared to be uppermost in the minds of the participants. During the discussion on the petroleum question, several of them commented that the increase in petroleum prices was causing great uncertainty as to the intentions of a number of developed countries regarding their foreign assistance

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commitments. No one explicitly cited the United States in this connection, but the Congressional action last winter rejecting Administration proposals to replenish the resources of IDA (the World Bank's soft loan affiliate) was clearly on their minds. One participant -- Mr. Paulo Pereira Lira, President of the Central Bank of Brazil -- went so far as to say that the real crisis was not the petroleum crisis but the crisis of the transfer of real resources. Another -- Mr. Alfredo Phillips, of the Bank of Mexico -- commented that no political will to proceed with the transfer of real resources to the developing countries was apparent. Mr. Phillips stressed that the developing countries needed to convince the developed countries that it would be in the interest of all concerned to establish reliable mechanisms to transfer real resources to the developing countries.

In this connection, Mr. Victor Bruce, President of the Central Bank of Trinidad and Tobago, told me in a private conversation that the developing countries were waiting for the United States to make a definite statement, one way or the other, on the proposal to link the issuance of SDRs and the extension of development assistance. He said that, if the link proposed was definitely out of the question this should be made known, and if the United States really favored a reliable method to transfer real resources to the developing countries, it would be helpful to know what plan the United States had in mind. One participant told Mr. Maroni that the statement on the link proposal made by Chairman Burns at a meeting of the Committee of 20 last July had been discounted by some

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Latin Americans who interpreted the fact that the statement was made by Chairman Burns rather than by Secretary Shultz as a maneuver which left the Secretary uncommitted on the issue -- and therefore free to endorse the link later if that proved to be politically desirable.

The Channeling of Bank Credit

Ten Governors commented on the channeling of bank credit, most of them to outline the experience of their own country. The principal analytical comment was made by Mr. Manuel Uribe, of the Bank of Mexico, who recognized the difficulties inherent in a system of selective credit controls, but stressed the need to employ such controls in the face of the serious imperfections with which the price mechanism operates in the developing countries and the difficult problems associated with the use of interest rates as a means of allocating resources in such countries. Mr. Uribe suggested that there was a need to assess the effects of such controls on the structure of production, the level of prices and the distribution of income, and to analyze their implications for the composition of bank assets, the relative economic position of various sectors of the economy, and the flow of savings to the banking system and to the securities markets.

I expressed the hope that CEMLA would undertake an analytical study of the problems raised in this connection, and in particular that it would attempt to assess the effectiveness of the many different mechanisms in use in the countries of the Hemisphere. I added that, in my opinion, CEMLA should not hesitate to assess also the techniques used

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in the United States to channel credit in desired directions. I pointed out that it would be helpful to us to have an objective dispassionate view of the merits of interest rate ceilings, for example.

The discussion on the channeling of credit was based on a survey of the techniques in use in the Hemisphere, undertaken by CEMLA following a suggestion which I made at last year's meeting. The CEMLA survey disclosed an enormous variety of techniques being applied, but CEMLA had not, so far, attempted any evaluation of their effectiveness.

The International Financial Posture of Venezuela

Before the meeting got underway, the participants heard a speech by Mr. Hector Hurtado, the new Minister of Finance of Venezuela, who outlined his country's financial views. He began by deploring the lack of progress on the reform of the international monetary system and the attempt of some developed countries to blame this -- and the world economic crisis itself -- on the recent increases in petroleum prices. He then assumed the attitude of championing the interests of the developing countries, while offering to help solve the financial problems of the world in a multilateral manner and in cooperation with the international institutions.

He stressed the adverse effects of the recent uncertainties on the transfer of real resources to the developing countries and the lack of political will in the industrialized countries to adopt new arrangements and rules of international financial conduct, and he described the petroleum problem as one of balance of payments adjustment to a new and irreversible situation as regards petroleum prices. He proclaimed a need for "fairer"

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prices for all raw materials and urged that closer ties be established among raw material producing countries to achieve this result. He complained that the profits of the large international oil companies were intolerably large and not in accord with the efficiency and the welfare of the world community.

He listed the steps taken by Venezuela to recycle part of its petroleum earnings, and announced the creation of a Venezuelan Investment Fund -- which, incidentally, will be headed by Mr. Benito Losada, a former President of the Central Bank, who is well known to several Board Members. This fund will undertake (among other things) the direct financing of development projects in other countries, as well as to purchase bonds and loan participations from international institutions.

He expressed support for the proposal of the Managing Director of the IMF to create a special oil facility in the IMF, but he warned that this facility must give priority to the needs of the developing countries, through rules of eligibility to borrow and a schedule of amounts which may be borrowed designed so as to prevent the developed countries from capturing the lion's share of the available resources.

<u>Policy Statement by the New President of Venezuela</u>

While the meeting was in progress, the new President of Venezuela -- who took office in March -- made an important policy speech in which he announced a series of economic and financial measures, including the nationalization of the iron ore concessions and of a supermarket chain owned by a Rockefeller enterprise, and the requirement that many foreign firms divest

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themselves of substantial shares of their Venezuelan holdings. These measures are causing much concern among American businessmen operating in Venezuela.

It is clear that the new position of wealth in which Venezuela finds itself is enabling it to be far more independent of foreign capital than it has been up to now. The acquisition of business interests now held by foreigners is, of course, one way to recycle a part of Venezuela's petroleum earnings.

Other measures announced by the President include a rather sweeping increase in wages -- while prices remain frozen -- a cut in the maximum interest rates on consumer installment credit, and higher taxes on the oil companies. I should add that there are persistent rumors that the Venezuelan currency will soon be appreciated. However, the Finance Minister has denied that this was in prospect.

Concluding Comments

My experience at this meeting, as at the one held a year ago, is that these sessions are very useful -- not only for the opportunity to exchange ideas and learn one another's points of view -- but also in establishing a rapport with the central bankers of the area. Because of the relatively frequent changes in the top positions of many of the area's central banks, these personal contacts must constantly be renewed. By participating at the highest possible level, we give concrete evidence that our expressions of concern for the area and of interest in its problems are genuine, and we strengthen the efforts of the U.S. Government to develop closer and more mature relations with the other countries of the Hemisphere.

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The next meeting will be held in Panama, approximately a year from now. An agenda committee to prepare for that meeting has been named, consisting of the Central Banks of Chile and Jamaica and the National Banking Commission of Panama.

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Appendix A

Meeting of CEMLA Assembly
and Meeting of
Governors of The Latin American Central Banks

Following the meeting of Governors of Central Banks of the Hemisphere, two other central bank meetings took place.

CEMLA Assembly

The Assembly of members of the Center for Latin American Monetary Studies, known as CEMLA for its Spanish language initials, met on May 1. CEMLA has 22 Central Banks as voting members, and 4 more -- including the Federal Reserve System -- as non-voting members. Another 18 institutions also participate as non-voting members.

The Assembly heard a detailed presentation by CEMLA's new Director, Mr. Adolfo Diz, of a program to institute major changes in the orientation and structure of the institution, aimed at strengthening its training, research, publication and information activities. The Assembly voted unanimously to endorse this program and approved a plan to increase and restructure the dues schedule so as to provide the financing which the program will require.

The Assembly also voted to admit two new voting members, the Central Bank of Guyana and the National Banking Commission of Panama.

Latin American Governors Meeting

The eighteenth meeting of the Governors of the Latin American Central Banks, which we were invited to attend as observers, was held on May 2. This meeting was conducted along lines similar to the hemispheric

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meeting which preceded it. The agenda covered (a) techniques to promote exports, (b) central bank capability and effectiveness in managing money supply, and (c) reports by the three Latin American Executive Directors in the IMF.

Before considering the items on the agenda, the meeting, acting on a suggestion of the Venezuelan Finance Minister, set up a working group, consisting of representatives from four Central Banksplus the three IMF Executive Directors, to make recommendations on the ways in which the Venezuelan contribution to the proposed IMF oil facility might be made available in order to ensure that the facility would give priority access to its resources to the developing countries. Because of lack of time, the working group made only a quick study of the matter and did not come up with detailed proposals before the meeting adjourned. But by requesting the recommendations of such a group, the Venezuelan authorities strengthened their posture as defender of the interests of the developing countries.

The discussion on export promotion brought out the fact that a number of countries are running afoul of the U.S. anti-dumping law and that the U.S. has imposed countervailing duties against some of the affected products. The participants expressed concern over this situation, and warned each other that export promotion devices should be reviewed to stay clear of such difficulties. The discussion also brought out the feeling, on the part of a number of participants, that existing facilities to finance Latin American exports are inadequate. The Argentine and Mexican representatives suggested the use of IBRD and IDB guarantees to permit more extensive discounting of export paper in foreign markets.

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The main paper on the management of money supply, presented by the Central Bank of Nicaragua, argued that the central banks of developing countries have no control over money supply, whether it be on the magnitude of the changes or on their direction, and that money supply is determined by decisions made by the public, largely independently of the actions of the Central Bank. The Nicaraguan representative admitted that this thesis was based on the Nicaraguan experience and that it was influenced by the fact that the Nicaraguan economy is open to international influences, has long enjoyed a stable exchange rate with few if any exchange restrictions, and is largely agricultural. But he claimed that it was applicable to other developing countries. The reasoning was involved and the meaning was not always entirely clear, but it appeared that the key element of the analysis was that changes in the balance of payments automatically absorbed any change in money supply that did not correspond to the domestic demand for money and thereby nullified the power of the central bank to control it. The paper suggested that, rather than attempting to affect the supply of money, central banks should seek to influence the factors which determine the demand for money, particularly credit expansion. The paper also suggested that the concept of money be broadened so as to include all liquid assets, "including obligations of any nature of bank and non-bank financial intermediaries."

In his prepared comment, Mr. Cano, President of the Central Bank of Chile, agreed that, in an open economy with a fixed exchange rate, the effectiveness of monetary policy was limited, but he suggested that the central bank did have control over the nominal amount of money supply. He pointed out that discrepancies between the amount of money created, in

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nominal terms, and the amount demanded by the public would have repercussions on the level of domestic prices, interest rates, and international reserves, but he argued that the Central Bank had means to deal with this situation, including the power to alter the exchange rate, or to impose exchange restrictions. He added that the speed with which these repercussions would occur would depend on the ease with which the public had access to credit, and he said that this was the reason why domestic credit expansion, rather than money supply, was the key variable for monetary policy. He noted that, since central banks in developing countries could not use open market operations to influence credit expansion, they often resorted instead to direct or selective measures of credit regulation. He agreed that it was desirable to broaden the analysis of the demand for liquid assets so as to include all obligations of the financial intermediaries, but noted that, since non-bank financial intermediaries are not regulated by the Central Bank, there was no need to include their obligations in the definition of money.

Mr. Victor Bruce, President of the Central Bank of Trinidad and Tobago, also presented a prepared comment. He reviewed the analysis which has led central bankers to focus on money supply in their attempt to influence the level of economic activity, and some of the reasons why this analysis has been questioned. He agreed that the wider definition of money suggested by the Central Bank of Nicaragua had merit. He stressed the limitations of the instruments of monetary policy in the developing countries, and the difficulty of controlling the influence on the money supply of the net foreign assets and the government deficit. He commented

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that the Nicaraguan paper in effect called for a reassessment of the approach to monetary policy and he expressed sympathy for this view.

In the ensuing discussion, the representatives of Peru, Mexico, and Argentina reviewed the experience of their country with their respective monetary management techniques. Mr. Barreto (Peru) and Mr. Uribe (Mexico) felt that their country's experience showed that money supply could be controlled. Mr. Gomez Morales (Argentina), for his part, said that monetary policy was a consequence of overall economic policy and that monetary management was useless unless it was incorporated in a comprehensive economic program.

The final session of the meeting was devoted to reports by the three Latin American Executive Directors in the IMF. Mr. Alexander Kafka (Brazil) reviewed the status of the C-20 negotiations. Mr. Carlos Massad (Chile) reported on the problem of formulating guidelines for a system of floating exchange rates. Mr. Guillermo Bueso (Honduras) discussed the progress being made toward establishing an IMF oil facility. This led to comments by Mr. Ricardo Ariazú, Alternate Executive Director in the IMF (Argentina), concerning the forthcoming review of IMF quotas. Mr. Ariazú pointed out that the Latin American countries are losing ground economically relative to the rest of the world, and warned that the area might experience adverse consequences from this in the quota review.

The next meeting of Governors of the Latin American Central Banks will be held in Mexico City in September, the week before the annual IMF/IBRD meetings.

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Appendix B

Latin American and Caribbean Comments on Petroleum Problem at the Meeting of Central Bank Governors

Ten participants commented on my presentation: Four of them represented oil exporting countries; three more were from countries which are nearly self sufficient in oil; one was from a country with some crude oil production; only two represented countries with no crude oil production.

Mr. Pereira Lira, President of the Central Bank of Brazil,[1/] said that he was glad to hear that the effects of the increase in petroleum prices on the industrialized countries were not as bad as had been feared at first. He noted that, for the first time, the developed countries were feeling the economic pressures usually felt by the developing countries. He agreed with me that it was now essential to reevaluate the traditional views on the balance of payments and to learn to accept large trade or current account deficits.

He recognized that the petroleum importing countries would suffer a loss of welfare and said that the problem for these countries was to find a way to absorb this loss without having to suffer a lower rate of economic growth. He concurred in what I had to say about the dangers of stimulating demand in the present circumstances.

He played down the problems associated with the recycling of the surplus earnings of the petroleum exporting countries. He said that the Euro-currency markets were accustomed to handling short-term liabilities and

1/ Brazil produces only about 25 per cent of its petroleum needs.

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extending long term credits and that the bankers operating in these markets should be able to cope with this problem in the future. He noted also that the petroleum exporting countries had expressed a willingness to recycle and that this should allay the fears of those worrying about balance of payments equilibrium. He suggested that the amount of recycling and the terms under which it might take place could be dealt with in later discussions. He pointed out that the proposed IMF oil facility would help and that some developing countries -- notably Brazil -- had ample reserves to tide them over the initial period -- although this was not the case for the developing countries as a group. He said that the developed countries had an important role to play in channeling funds to the developing countries and that the problems of the latter would be greatly eased if the former would only increase their level of official development assistance in accordance with the targets sanctioned by the United Nations -- so as to bring it to 7/10 of 1 per cent of GNP.

He placed the additional import cost for Brazil in 1974 as a result of the increased oil import bill at about $2 billion. He said that the Brazilian authorities were hoping that this would not have unduly large adverse effects on other imports and that the rate of growth of GNP would not suffer much.

He concluded that the real crisis for the developing countries was that of the transfer of real resources which is endangered by the uncertainties stemming from the higher oil prices.

Mr. Espinosa, General Manager of the Central Bank of Ecuador,[1/] took exception to my having stated that the petroleum situation stemmed

1/ An oil exporting country.

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from a unilateral action by the oil producing countries. He said that there was nothing new or unusual about acting unilaterally and that developed countries acted this way often. He cited the unilateral declaration of inconvertibility of the dollar and the unilateral decision to float currencies hitherto considered firmly anchored. He said that it was not fair to single out the oil producing countries for criticism on this score.

He defended the decision to raise oil prices, noting that it reflected changes in market conditions, that the oil producers were facing ever higher prices for their imports, that luxury consumption and wasteful uses of oil had to be curbed, and that the oil companies were earning intolerably high profits. He suggested that the increase in oil prices had opened the door to increases in other prices which, he said, had long been held too low.

He expressed confidence in the recycling decisions of the oil producing countries and in the ability of the consuming countries as a group to recapture the additional cost of oil imports, and voiced optimism in the ability of the world to handle the problem through cooperative action.

Mr. Barreto, President of the Central Reserve Bank of Peru,[1/] said that the oil crisis made it possible to appreciate more clearly the crisis of the world economy and of the monetary system. He took the position that both stemmed from the inflation which has been allowed to

1/ Peru produces about 70 per cent of its oil needs.

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persist for so long in so many important countries. He added that the maldistribution of world liquidity had made matters worse and helped to perpetuate the disequilibrium. He urged a redistribution of world liquidity and the adoption of coordinated policies to prevent it from again becoming maldistributed. He suggested that the redistribution of liquidity being accomplished through the increase in oil prices presented a unique opportunity to apply these principles.

Mr. Branda, Vice President of the Central Bank of Uruguay,[1/] noted that his country had little access to additional financing and that petroleum imports would reach $170 million, or 35 per cent of total imports, in 1974. He said that this percentage had never exceeded 15 per cent in the past, and that it would take a tripling of meat exports -- the country's principal export -- to pay for such a large jump in oil import costs. He said that such an increase in meat exports was not feasible. He also said that the higher cost of oil would intensify inflationary pressures in Uruguay by an estimated 5 per cent.

Mr. Bruce, President of the Central Bank of Trinidad and Tobago,[2/] said that his country was a small oil producer and would derive some benefits from the price increase. He agreed that the producing countries must finance the deficits of the consuming countries and he indicated that some recycling proposals by his country were about to be presented to the other countries of the Caribbean area for which Trinidad and Tobago has special responsibilities. He added that his country has offered to purchase IDB bonds and that discussions have begun looking to the purchase of IBRD bonds.

1/ There is no crude oil production in Uruguay.
2/ An oil exporting country.

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Mr. Phillips, the Bank of Mexico's[1] Manager for Relations with International Organizations, said that the petroleum problem merely intensified the problem that the world economy was already facing. He said that, in addition to the effects on aggregate demand, employment, and prices, there was a specific effect on the fertilizer industry which would hurt most those least able to afford it. He noted that the search for new energy sources was beyond the reach of many developing countries which cannot afford the high cost investment required. He expressed some misgivings about the ability of many developing countries to tap the financial markets of the world in competition with the developed countries, some of which have already tapped them for what he called astronomical amounts. He complained that the intentions of the developed countries regarding the transfer of real resources were not clear and that there appeared to be no political will to proceed on this matter in those countries. He urged the developing countries to work to convince the developed countries that it would be in the interest of all countries to establish reliable mechanisms to transfer real resources. As for Mexico, he said that it was nearly self sufficient in petroleum and that it hoped to be fully self sufficient soon.

Mr. Gomez Morales, President of the Central Bank of Argentina,[2] expressed pleasure that the problem was being discussed realistically as a fact. He agreed that the effects on the balances of payments and on the negotiations for a new financial order in the world were paramount. But he stressed that, in his opinion, the failure of the reform efforts was due to

1/ Mexico produces nearly 90 per cent of its oil needs.
2/ Argentina produces nearly 90 per cent of its oil needs.

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a lack of political will, and not to the rise in petroleum prices. He suggested that to finance the oil deficits would merely postpone the day of reckoning for the borrowers and would saddle them with ever increasing interest payments. He indicated that Argentina was nearly self-sufficient in petroleum and that it was making efforts to increase other forms of energy production to fill the gap.

Mr. Silva, First Vice President of the Central Bank of Venezuela,[1/] noted that the developing countries have long suffered adverse terms of trade and that this had recently begun to change. He viewed the increase in oil prices as a step to redress the relative price position for the producing countries. He pointed out that the Paley Commission, which prepared projections on the need for basic resources in the early 1950s, had grossly underestimated the demand for 1975.

He complained that it was wasteful to use petroleum as fuel when it could be used productively in the petrochemical industry and in many other ways, including the production of proteins. He placed the blame for the world financial crisis on the lack of fiscal discipline in the key currency countries. He added that world inflation and the depreciation of key currencies had reduced the purchasing power of the export earnings of the developing countries in general and of the oil producing countries in particular. This, he said, made it reasonable to raise oil prices. He admitted that the higher oil prices would have an impact on world price levels, but he noted that sharp increases in other commodity prices -- especially wheat, sugar, and soybeans -- were also contributing heavily to the rising trend of world prices.

1/ An oil exporting country.

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He emphasized Venezuela's cooperative attitude, citing its decision not to cut oil output when other producing countries did. But he failed to mention Venezuela's announcement, last month, of a 7 per cent cut in output to reduce the amount of gas being flared at the wells.

He listed the steps taken by Venezuela to recycle some of its oil export earnings: (a) its efforts to promote the creation of an OPEC development fund; (b) its agreement to IDB and IBRD bond issues in the Venezuelan market; (c) its decision to create and endow a development trust fund in the IDB; (d) its decision to make contributions to three regional development banks -- the Andean Development Corporation, the Central American Bank for Economic Integration, and the Caribbean Development Bank -- (e) its decision to incorporate petroleum in the system of reciprocal credits in use among the member countries of the Latin American Free Trade Association -- in effect deferring payment for petroleum for a number of months beyond the customary payment period; and (f) its decision to earmark 50 per cent of its petroleum revenues for a National Investment Fund, one of whose functions will be to finance development projects in Latin America.

Mr. Mercado, President of the Central Bank of Bolivia,[1/] said that the countries producing basic commodities other than oil were just as badly affected as the oil producing countries by the chronic deterioration in their terms of trade as their import prices rose without interruption over the years. He said that this condition needed to be corrected and that this was

1/ An oil exporting country.

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especially important when they were among the least developed of the developing countries.

I thanked those who had spoken for their comments and I remarked that only one of them represented a country (Uruguay) totally dependent on imports for its oil supplies. I said that, since there were 12 such countries in the region and since the impact of the oil crisis on them was bound to be severe, it would be interesting to hear from a few more representatives of this group of countries.

Only one, Mr. Fernandez, President of the Central Bank of the Dominican Republic[1/], responded. He said that his country's oil imports in 1974 would exceed 25 per cent of total imports. He expressed appreciation for my concern over the plight of countries totally dependent on imports for their oil supplies, and for Venezuela's announced intentions to help. He added that his country was benefitting from a rise in the price of its principal export (sugar), and he noted that the price of sugar was responding to the pull of demand rather than to a curtailment of supplies.

1/ The Dominican Republic has no crude oil production.

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ELEVENTH MEETING OF GOVERNORS
OF CENTRAL BANKS OF THE AMERICAN CONTINENT
CARACAS, VENEZUELA

THE ECONOMIC IMPACT OF THE RECENT CHANGE IN THE SUPPLY AND COST OF PETROLEUM

By

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THE ECONOMIC IMPACT OF THE RECENT CHANGE IN THE SUPPLY AND COST OF PETROLEUM

Since last October, all of us have come to realize -- in both our personal and official lives -- the way in which a reliable and economical supply of petroleum has become vital to our well-being. The history of this period -- the imposition of supply cutbacks and embargoes, the enormous escalation of prices -- is widely-known, and I will not describe it again. Nor do I wish to discuss the rights or wrongs of the political aspects of what has happened. Instead, I want to explore the economic and financial implications of the situation as we find it today -- and as it is likely to develop in the period ahead. Specifically, the question is this: how can consumer nations best adjust to the real and financial consequences of a dramatic and abrupt rise in the cost of energy, and, in the longer run, reduce our reliance on uncertain and environmentally harmful energy sources?

Impact on Real Incomes

First, I would like to turn to an analysis of the impact on real activity in oil-importing countries of the drastic rise in the price of imported petroleum. The circumstances of this increase are without precedent, so far as I know, and we must stretch our imaginations a bit to grasp the nature of the problem. What makes this situation unique is that a group of oil-exporting countries has unilaterally been able to impose an additional cost that could amount to over $65 billion per year at current prices on their exports to the rest of the world. Yet,

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it is highly doubtful that they can increase their purchases of other countries' goods and services by more than perhaps $15 billion this year -- leaving a gap on the order of $50 billion. This means that the rest of the world cannot begin to repay the debts for these imports in real terms -- that is, with goods and services -- until some time in the future when the oil-producing countries as a group may begin to import more than they export. Needless to say, there are great differences among the oil-exporting countries in their propensities to import, but I believe the above statement holds as a general proposition.

No one can say how long such a distorted pattern of trade and payments can persist. Rapid development of alternative energy supplies (together with conservation measures) is likely to drive down the present extreme prices for oil. But even if this happens, we will probably still have an imbalance that for some countries would involve disastrous declines in real income.

I will discuss later the consequences on the financial side and for balances of payments of this enormous current account surplus of the oil producers. But let us consider first what it means for real incomes in oil-consuming countries and for the changes in economic structure that will result. Since only a small part of the increased cost of oil imports can be paid for with real transfers in the short run, there need not be a drastic immediate reduction in the real incomes of people in the consuming countries, taken as a whole. However, it will take very careful management to avoid serious deterioration of economic activity within countries as we work through the adjustment period. Indeed, the international community faces an unprecedented task of ensuring that the burden of real adjustment does not become unbearable for some countries.

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It seems clear that for the industrial countries the original impression that a sharp decline in real economic activity was bound to occur is now giving way to a calmer analysis that the drag on activity resulting from the oil problem would be less significant. Part of the change in view reflects a better outlook for supply as oil production levels have been raised, and another part stems from a change in the over-all outlook for economic activity in most of these countries. This will be helpful to many countries who will find strong markets for their products.

It is often said that higher prices for oil have a dampening effect on consumer demand analogous to that resulting from an increased excise tax. However, the analogy should not be pushed too far. Since this is a tax on one highly important product, relative costs and prices within the economy as between energy-intensive industries and commodities and others are shifted very markedly. In the United States, for instance, where over one-third of the oil consumed is used for automobiles, that industry -- and all the sectors that have come to depend on the use of automobiles -- has been hit especially hard. In other countries, the impact may come most severely through higher costs of fertilizer or other imports. This is essentially a tax being imposed from outside, rather than as part of a national plan designed to achieve particular national objectives.

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Authorities in the oil-consuming countries, therefore, have to cope in this adjustment period with a reduction in real consumer incomes over which they have no control, distortions among industries, large and persistent deficits in their external transactions, and, last but far from least, a strong upward push to rates of inflation that are already far too rapid.

Energy and the Management of Domestic Demand

Before the emergence of the energy problem, authorities had formed some impression of the outlook for their economies, and they had determined the kinds of policies that might produce the best combination of real growth, price stability, and reasonable external balance. Those goals are still valid, but the policy mix may have to be changed to meet the new situation. One question to be dealt with is the potential behavior of consumer incomes and expenditures. If we assume that consumers have little scope for meeting increased oil costs out of current savings, then we have to consider whether there will be a serious decline in their expenditures for other goods and services. When the situation for over-all demand is serious, an appropriate response under ordinary circumstances might be to make an adjustment in government revenues or expenditures -- aimed largely at bolstering consumer incomes. However, at present, many countries are going through a period when shortages of supply of many materials and intermediate products have become acute, and prices have been moving up much too rapidly.

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That situation would seem to call for a determined effort to alleviate shortages and remove obstacles to supply, while keeping a rein on demand. The perennial trade-off between the appropriate shares of investment and consumption in the economy is sharpened by the energy problem. The need to create new energy sources -- and to adjust industry toward less energy-intensive processes and products -- is speeding up the investment process and dictating an emphasis on investment over consumption in the near term greater than had been contemplated.

It seems to me that the adjustment to be made cannot be accomplished simply by stimulating demand to restore consumer spending power. Rather we need more selective measures to deal with sectors of the economy most severely affected by this new situation. Consequently, I would be extremely cautious about the use of monetary policy to offset any weakening in demand associated with higher oil prices. I would not try to suggest the size of the problem that may exist in individual countries, or the specific features that require a particular response. Indeed, within the Western Hemisphere we have many examples of countries who will be little affected, as well as many who will be in great difficulty. I hope each representative will offer his own assessment in the discussion period. However, it might be helpful if I assess the impact of the energy crisis on the U.S. economy.

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Impact on the U.S. Economy

At the time the oil embargo was imposed in the fall of 1973, economic growth in the United States was already slowing. To some degree, the moderating pace of activity last year reflected the influence of accelerating inflation on consumer buying. Sales of automobiles began to slip in the spring of 1973, as did sales of other durable goods. The effects of credit restraint were also evident in a sharply declining pace of new housing starts. However, activity in the industrial sector was also hampered by widespread shortages of industrial materials and component parts.

Thus, the embargo hit at a time when demands were weakening in some sectors and shortages were limiting production in others. Partly as a consequence, expectations developed of a decline -- probably shortlived -- decline of business activity and of intensified inflationary pressures. There were, however, great uncertainties as to the probable effects of the embargo that were related to questions regarding the extent and duration of the shortfall in imports and the sectoral distribution of shortages in the U.S. economy.

The strategy of the U. S. Government in dealing with the oil crisis was to design policies to insulate the industrial sector of the economy from the effects of the shortage of oil -- with the hope of avoiding widespread declines in output and employment. To achieve this objective, the Administration reduced the allocation of fuels for consumer uses. Allocations of fuel for commercial

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and industrial space heating and for commercial air travel were also curtailed.

By and large, the objective of the Government's energy policy appears to have been achieved. There is little evidence that industrial production was held back by shortages of petroleum used for industrial heating or as raw material. The major adverse effects of the oil shortage were concentrated in industries related to travel, especially passenger car use. Sales of new domestic type automobiles were hard hit--dropping 30 per cent by February, 1974. Declines were extremely large among big car sales, because of the uncertainty of gasoline availability and the sharply rising cost of gasoline. Demands for small cars, meanwhile, remained strong and inventories of these models were drawn down. Activity among automobile supplying industries; sales of conventional homes in outlying suburban areas; sales of mobile homes; sales of recreational vehicles, and sales of other travel-related goods and services -- were also cut back.

These adverse effects began to be evident quite promptly. Industrial production began to decline in December, and it continued to fall in the opening months of 1974. Unemployment in the first quarter of 1974 rose to 5.2 per cent of the labor force, compared with 4.7 per cent in the fourth quarter of last year. Real GNP growth in the first quarter probably declined appreciably -- at a 5.8 per cent annual rate, according to the preliminary estimate.

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Nevertheless, the economy appears to have come through the winter decline without developing the cumulative characteristics that often accompany a softening in output. Secondary effects appear to have been minimal, and declines in employment and production have been concentrated mainly in travel-related industries. Moreover, automobile sales recently appear to have leveled off, and sales of larger cars have actually improved somewhat. Housing starts have also stabilized, and retail trade in lines other than automobiles has remained relatively good.

Capital spending of business has remained particularly strong, and this has been an important factor sustaining the overall economy. New orders for durable goods have continued to rise and the backlog of unfilled orders has grown further. The Commerce Department recently reported that total plant and equipment expenditures planned for 1974 were, on balance, unchanged by the energy crisis. The petroleum industry reported a large upward revision in expenditure plans, and there were also substantial upward revisions for gas utilities and railroads. Cutbacks in plans were reported for motor vehicle manufacturers, air transportation, electric utilities, and the commercial and other sector.

With the oil embargo now lifted, the prospects for some pickup in economic activity over the remainder of the year have improved materially. Nevertheless, adjustments to the energy problem will probably continue to plague the economy over the remainder of 1974. Prices of gasoline and heating fuel have risen dramatically since last fall, and as increased supplies of

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fuels become available, a larger part of consumer buying power will be absorbed by increased purchases of these goods. Furthermore, consumer demands for large cars, mobile homes, recreational vehicles, and homes far out in the suburbs may prove to have been permanently reduced by higher fuel costs. The rise in economic activity that can reasonably be expected over the remainder of 1974 may, therefore, be less vigorous than is characteristic of a typical cyclical recovery.

Prices, meanwhile, continue to rise rapidly. There is some hope that the rate of increase in domestic prices will moderate later this year as petroleum prices level off in response to the substantial adjustments now underway in oil markets and as our food supplies expand because of larger harvests. However, the inflation underway does not yet show concrete signs of abatement. Industrial commodity prices are still rising sharply, and unit labor costs are also increasing rapidly.

Public policy at the present time is confronted with a most difficult problem. Inflationary pressures are likely to continue at a very high pace through 1974, even though economic activity may remain sluggish, with unemployment rising further. Any effort to bolster aggregate demand would worsen an already grave inflationary problem. Yet, some response to the effects of the energy problem is clearly in order.

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In the present environment, it has seemed wise to use selective fiscal measures to alleviate unemployment and to avoid the broad stimulus that would come from a general relaxation of fiscal and monetary restraint. Proposals are under consideration to enlarge our public employment program and to increase unemployment benefits as a means of cushioning economic adjustments to the energy problem.

Impact on International Balance

Let me turn now to the balance of payments and international financial consequences of the oil problem. The higher price of oil will no doubt reduce the demand for oil well below previous estimates for 1974. Moreover, this higher price has certainly made obsolete the projections that showed huge increases in oil imports from the OPEC countries as we go out toward the end of the century. But even if demand is held down, the likely demand even at present price levels will generate export revenues on the order of $90 billion for the oil producers this year and a net current account surplus on the order of $50 billion. In 1974 alone, the increase in the net import bill for oil of the developed countries as a group will be about $50 billion; for non-oil exporting LDCs the oil import bill will be increased by perhaps $9-10 billion. In the Western Hemisphere, the effect on Canada is about neutral (since Canada's imports and exports of oil are roughly equal). Of course, Venezuela will generate a huge surplus, and some other countries in Latin America will be able to supply most of their own needs or even export some surplus oil production. For the United States, the extra cost of oil in 1974 will be perhaps $15 billion, and for countries in Latin America, other than oil producers, the increased price for oil could impose a balance of payments burden of $2½

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billion. As I understand it, the countries in this region that would be hardest hit would be those of Central America, as well as Paraguay and Uruguay and some Caribbean countries.

As I noted above, to the extent the oil producers will not be paid in goods or services for their petroleum, they must, one way or another, store up savings (mainly channeled into investments in the rest of the world) or use them to provide aid to countries in need. Consequently, when the oil consumers look at their balances of payments, they will all see much larger trade deficits than expected -- and much larger deficits than have been thought of as being sustainable over any long period. Moreover, efforts by any individual country to reach a goal for the trade balance that earlier had seemed reasonable may only succeed in pushing other countries into more serious difficulties. We have a new and difficulty task of analysis and policy adjustment.

The financial side of the trade imbalances created by the jump in oil prices presents a host of new and formidable problems. If these imbalances persist for even a few years, the accumulation of external investments by the oil producers would reach dimensions never before experienced -- with managements problems that might prove to be

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insuperable. I would emphasize that the greatest immediate danger we face is that -- while some countries may find their need for financing of their deficits automatically taken care of as oil producers' funds are recycled through the market -- others will have much greater difficulty in obtaining financing and will need help quickly and perhaps over a very extended period.

Recycling Surplus Revenues

Perhaps I should discuss very briefly the process of recycling these enormous surplus revenues of the oil producers. At this time, the revenues are paid largely in dollars and some sterling, and they are initially paid to the accounts of these countries in the Euro-market banks and, to some extent, in banks of individual countries. In the present early stage of the evolution of these financial flows, we are dealing largely with flows through banking channels. The banks, of course, must find appropriate outlets for these funds, and they must resolve the problem, as they see it, of matching very liquid liabilities with longer-term assets. Oil producers' revenues are just now reaching the scale they are likely to sustain -- at least for a while. Already some consuming countries have anticipated the need for financing and have raised loans in the market somewhat ahead of the arrival of the supply of funds from oil producers. In these early stages, the Euro-markets have been effectively providing a meeting place for the demand and supply of funds, but we may soon see stresses appearing that the market may not be able to resolve by itself. One kind of stress will occur if the banks become apprehensive about accepting such enormous

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amounts of funds from so few depositors, or because funds are being attracted in too large amounts to countries with higher interest rates. Moreover, there are few financial markets that are large enough to absorb such flows without extreme distortion.

Another kind of stress will occur as the producing countries accumulate funds far in excess of any possible need for imports and development of their domestic economies. We should expect them to make an effort to balance off the advantages of adding to their assets against reducing the level of oil production. Thus, the quality of the investment portfolio is important as a factor in helping to sustain a desirable level of production.

But the crucial problem, if we are to share the burden of higher oil prices equitably, is to see to it that financing is available to countries threatened with a drastic decline in real incomes. Many countries will be incurring debts that take the form of short-term or medium-term credits -- but will in fact be debts that cannot be repaid as long as payments of this size must be made for oil. We cannot expect market institutions to meet such extraordinary and accumulating credit needs over long periods.

I hope there is by now a growing recognition on the part of the oil producers that they have an obligation to help finance countries who cannot afford these higher prices. Among the actions that have been announced, I should certainly put high on the list the offer of Venezuela to set up a trust fund within the Inter-American Development Bank to extend loans to countries in this area. I understand that a portion of the funds will be lent on concessionary terms and that Venezuela has also

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agreed to purchase bonds of the World Bank and the Inter-American Development Bank. Another initiative is the action taken by the Organization of Petroleum Exporting Countries at a recent meeting in Geneva to set up a special fund to cushion the impact of higher oil prices on the poorer countries of the world.

The Arab countries have organized a number of instrumentalities to provide financing for similar purposes, and Iran has been willing to contribute in various ways, including responding to the initiatives of the IMF and the IBRD in their efforts to bridge over the immediate financing problem.

Nevertheless, we are still pretty much in the dark as to the aggregate amounts involved in these actions, and in many cases the lender appears to be expecting a return comparable to that provided by investments in financial markets. Perhaps this is because the time has been too short for the full scope of the financing problem to be grasped. It seems to me that -- if the oil producers really wish to avoid imposing a loss in welfare on the poorer countries --they must be prepared to fund the incremental cost of oil to such countries over an indeterminate period at highly concessionary terms. This does not mean at all that the developed countries can relax their aid efforts, since such aid will be needed at least as much as before to support the hoped for gains in real per capita incomes.

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Concluding Observations

We are all at an early stage in identifying the problems that the new oil situation has created, and up to now we have been thinking mainly of the problems more immediately ahead. One danger in this situation is that we may lose sight of some of our longer-run objectives. I have in mind, for instance, the temptation to enter into barter arrangements of one kind or another to assure supplies of necessities, or attempts to control and manipulate markets for scarce commodities. Whatever short-term advantages such schemes may seem to have, I am convinced they would lead to far less than optimal use of the world's resources, and they would inevitably bring reprisals and countermeasures of all kinds.

In the period ahead countries will need to review their current account targets to ensure that, apart from extraordinary payments for oil, they continue to progress in an equilibrating direction. This will help to support an adequate net transfer of real resources from wealthy countries to those who need help for development. To sustain such a flow of real resources will require, as I have pointed out, a comparable rechanneling of the financial flows that will be going to the oil producers.

Even if there were not an energy problem, we would be struggling with the problems of economic development, inflation, the international monetary system, and the reduction of barriers to international trade and investment. We should not let the energy problem distract us from dealing with those issues. I would like to conclude with an optimistic

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expectation: working together, I am reasonably confident that we will not allow economic progress to be set back by this dramatic new development. I also expect that we will succeed in developing new energy sources that will greatly improve the quality of life in the future.