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

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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,

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.

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.

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.

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.

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

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.

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

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.

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

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 difficult 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 management problems that might prove to be

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

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

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.

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

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.