For release on delivery

Statement by

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before the

Subcommittee on International Finance

of the

Committee on Banking and Currency

U.S. House of Representatives

August 13, 1974

Mr. Chairman and Members of the Subcommittee:

I welcome the opportunity to discuss with you some of the problems created by the enormous increase in the price of oil in the past year. As a result of that increase, oil-consuming nations will be paying out over $100 billion a year to the oil-exporting (OPEC) countries at current prices and volumes, an increase of some $80 billion in the revenues of these countries in one year. Even after allowing for a steep rise in their expenditures for imported goods and services, the OPEC countries will be left with a surplus of funds available for investment of some $60 billion. This surplus will almost certainly diminish as time goes by, either because the price of oil is reduced to levels more compatible with a stable world economy, or because the OPEC countries will use a greater share of their increases to buy capital and consumer goods and services from other countries, and to provide assistance to countries most severely affected by rising costs of oil. Nevertheless, without trying to project into the more distant future, we must address our attention to the likelihood that the OPEC countries will have huge surpluses for some time to come.

In analyzing the consequences of this enormous new flow of funds in the world it is helpful to look first at the real impact on income and investment in the consuming countries and then to consider the financial problems related to managing this flow of funds. These two aspects of the oil situation are interrelated, of course, and if the financial mechanism does not prove equal to the demands that will be placed upon it the consequences will enormously aggravate the already severe problems of the real sector.

Effects on Economic Activity

The first immediate and obvious effect of higher prices paid for OPEC oil is that funds are pulled out of the income stream in the consuming countries, and, since as a group the OPEC countries cannot for some time spend more than a fraction of these funds on current output, there is a relative reduction in consumer demand. You will recall that last October we also confronted a reduction in supply, when we were faced with a cut in oil imports, which would also have reduced production capabilities. This situation set in motion an effort at planning in individual countries, and multilaterally through the follow-up on the energy conference held in Washington in February -- to share research programs, to reduce dependence on imported petroleum and to share oil in the event of further embargoes. In the U.S., Project Independence got underway. I would regard it as a serious mistake if we should allow the more relaxed supply situation to cause us to slow down these efforts. For the United States in particular, the most effective way to deal with the energy problem is to mount a strong national program for holding down energy use and moving as quickly as possible to develop substitutes for imported oil.

Not only will this give us some leverage in dealing with the present price and supply problems -- it will move us in the right direction for the long-run benefit of the country.

In some ways the effect of the jump in payments for oil can be likened to an excise tax -- cutting down consumption of oil itself as the price rises, and cutting consumption of other goods to the extent more is spent for oil -- directly and indirectly. But there are important differences: the quasi-tax is levied by foreign governments rather than by a domestic government, and the use of the funds is not under our control, although, as I shall point out later, we can nevertheless guide the shifts in demand and output that will result from the quasi-tax. As I shall point out, the desirable shift of production is in the direction of more investment.

It is important to note that while these payments to OPEC countries tend to dampen consumption demand in the oil-consuming countries, and may cause severe sectoral dislocations in some countries, they do not in themselves reduce our over-all productive capabilities. Recall that when the oil price change was occurring the United States and other industrial countries were approaching together the crest of a remarkable boom in world demand -- accompanied as you know by an explosion of world prices as our economies were being driven at near to full practicable capacity. By the fall of 1973 nearly all governments were trying to put a lid on this boiling over of demand, and were adopting more restrictive fiscal and monetary policies. In that context, there was no reason to be concerned about the demand-depressing effects of higher oil payments, so that any advocacy of expansionary policies to compensate for them was clearly misplaced. Now, as we and other countries are experiencing an abatement of the boom, we must be increasingly aware of the fact the rise in oil prices has consequences that depress activity, as well as those observed initially that were inflationary.

One result of the contraction the oil situation has caused in aggregate consumer demands, and in investment demands of some sectors depending on petroleum, is that there is some additional room for investment elsewhere to take place. This substitution does not automatically take place -- we need to take whatever steps we can to shift more of our economic activity from consumption into investment. Such a shift will redress the imbalance between demand and potential supply that underlies the problem of inflation. Stepping up investments in the energy sector is especially important. The financial requirements of such ventures are huge and we should give thought to the problems of financing these investments, which we have the economic capacity to make.

I would now like to turn from questions of reordering our domestic priorities to the more general problems of all oil-importing countries, and shall focus first upon those countries that are hardest hit, many of them less developed, but some also among the industrial countries. If the less developed countries that are severely affected cannot afford to buy the oil they need, or the food and fertilizer they need, their present already low standards of living will fall further, and their hopes of making some gains by industrializing will in many cases have to be shelved. Unless adequate ways to help these countries are found, an important part of the real cost of adjusting standards of living to pay for oil will fall on those countries least able to bear such a burden. Food prices are now rising generally, and the added problems of paying for fuel and fertilizer may well reach the point of depriving some countries of their minimal subsistence needs, posing very harsh alternatives. It can cogently be argued that the additional problems of these developing countries should be the responsibility of the oil-exporting countries.

We can see how the burden of high oil prices will impact if we look at the way in which the balances of payments of different groups of countries are likely to be affected unless these prices come down. The OPEC countries will have a huge surplus in their current account -- an export surplus -- amounting to perhaps $60 billion or more per year at current prices. They will dispose of this surplus in various ways; some will go into bilateral aid programs, or into the international institutions, and this can help take some of the strain off the poorer countries; but the bulk of the funds will be placed in the capital markets of the wealthier industrial countries. The industrial countries, as a group, will have a large current account deficit with the OPEC countries. In the aggregate, however, this will be automatically financed -- if my presumption about capital investment plans of the OPEC countries is correct -- by a capital inflow from OPEC countries. This is another way of saying that these wealthier countries as a group will not have to, and will indeed not be able, to pay for their full oil imports by exporting goods and services, until such time as the OPEC countries can absorb imports equal to their exports; and indeed they will not be able to repay their debts, again as a group, until the OPEC countries begin to run trade deficits, perhaps after the exhaustion of their oil or its replacement by alternative energy sources that the high oil price is likely to encourage. This is not to say there will not be problems of adaptation in the industrial countries of the sort I mentioned a moment ago. It does mean that, provided the oil deficits can be financed, real incomes need not be much different from what they would have been without the rise in oil prices. But that is not true for those industrial as well as developing countries that will not, through the workings of the market, or through public policy measures, be able to attract an inflow of capital that will take care of their new import requirements. These countries can in some cases run down existing reserves. After that, they would face drastic adjustments unless they receive support. Taking these three groups of countries as aggregates, we find one group, the OPEC countries, very much better off both in terms of current incomes and in terms of their claims on future world production; we find a second group, the wealthier countries with attractive capital markets, or good capacity to borrow, that are very uncomfortable perhaps about a rising debt to OPEC countries, but would be able to cope with the relatively small loss of real incomes that might occur; and we find another group of countries -- some counted as LDC's and some counted in the ranks of industrial countries -- who will face serious difficulties. Their difficulties may in turn react adversely upon the countries originally in a more favorable position.

I remarked just now that some of the wealthier countries may be increasingly uncomfortable about a rising debt to OPEC countries. In fact, some countries dislike the idea so strongly that they may resolve to avoid it by bringing their current account into balance -- that is, they may try really to pay for oil by either increasing exports or decreasing other imports well below the levels that would otherwise be observed. This sounds very virtuous -- we all feel that going into debt should be limited and should be for some productive purpose. But the rest of the world happens to be in a unique situation vis-a-vis the OPEC countries -- until those countries as a group buy more than they sell, they can only pile up financial surpluses abroad. Thus, if each consuming country -- acting in what appeared to be a rational fashion -- tried to avoid going into debt there could only be a greater debt accumulation by other consuming countries. In real terms, the countries avoiding debt would be paying for their oil currently, while other countries would find that their trade balance being driven into deficit more than would otherwise be the case and that their debt was increasing. In effect, some countries would be unloading their deficits upon the rest. They might do this either by using direct controls to affect their trade balance, or manipulating their exchange rate to depreciate it, or taking some extra measure of restraint to hold down domestic demand. The holding down of demand may in many cases be entirely desirable in order to curb inflation or eliminate any payments deficit arising independent of the oil situation. Such deficits exist now, and the countries experiencing them should indeed eliminate them. But if many countries try to eliminate those deficits resulting from the rise in the price of oil, we would, I believe, be in serious danger not only of a major setback in world economic activity but also of a breakdown in the rules for fair trade among nations that could take us back to the practices of the 1930's.

We have not come near to such a state of turmoil in the world trading system. I believe we can avoid it. But it is difficult to predict the decisions of nations when they find themselves confronted with major difficulties. Some countries may well consider the problems confronting them insolvable at the present price of oil. In the absence of a substantial reduction in that price unforeseeable conditions could develop that could make the situation difficult if not impossible to manage.

I would like to turn now to the U.S. balance of payments, and to the effects of the oil crisis on our international position. Our trade balance has already felt the weight of the sharply higher cost of imported fuel -- in the second quarter of this year we were paying $28 billion at an annual rate for fuel imports -- about $20 billion more at an annual rate than we were paying a year ago. This is almost entirely a price effect -- in volume terms imports of fuels were nearly unchanged. Mainly because of rising fuel imports, our trade balance for all goods has worsened sharply from a surplus at an annual rate of $4.2 billion (balance-of-payments basis) in the fourth quarter of last year -- when we reached the high point of recovery from the deep deficit in 1972 -- to a deficit at an annual rate of nearly $7 billion in the second quarter of this year. However, our underlying trade balance, that is, abstracting from the arbitrary increase in oil prices and also leaving out the extraordinary jump in agricultural exports, has shown considerable strength, moving steadily from a deficit at an annual rate of about $12 billion in the first quarter of last year to a deficit of only about $1 billion in the second quarter of this year. In volume terms we have done even better, with export volumes rising and import volumes no higher than they were early in 1972.

So far as our merchandise trade is concerned, we seem to have made the kinds of gains in competitive position that could be expected from the depreciation of the dollar since 1970, and this, together with the extraordinary rise in the value of agricultural exports, has helped to offset the huge jump in oil imports. However, like other countries we must be concerned with achieving an over-all balance in our accounts, including capital movements, that will underpin a stable dollar in exchange markets. The part of that underpinning that must come from an appropriate net inflow of capital from abroad could be significantly less than the extra $20 billion in payments due to the higher price of oil, if it turns out that there are sufficient improvements in the rest of our accounts.

There have been considerable gyrations in the exchange value of the dollar since the second devaluation in February last year. But since about mid-May the dollar has held fairly stable against a weighted average of the currencies of the countries that are our major competitors in world markets. As it stands now, the dollar has depreciated about 17 per cent against those currencies since May 1970, and has moved up slightly in recent months. On a broader measure, taking into account the movement of the dollar against a weighted average of nearly all foreign currencies, the devaluation of the dollar has been appreciably less -- amounting to perhaps 12 per cent since 1970. The smaller depreciation measures the dollar's so-called "effective rate," against the world as a whole. The reason for the difference between the two measures is that while the currencies of most of the major industrial countries have appreciated quite sharply against the dollar, those of numerous other countries, including most of the developing world, have tended to stay with or near the dollar. It is the average rate relationship that comes closer to representing the longer run effects on our balance of payments, rather than changes from time to time against particular foreign currencies.

Recent relative stability of the dollar has of course been gratifying. It has materialized within an environment of floating exchange rates, in which very wide swings had occurred during the 12 months following the breakdown of the fixed rates system in February-March 1973. Rate flexibility has proved its usefulness in times of severe disturbance. It has given rise, on the other hand, to new concerns. Among these has been the fear that flexibility might be abused to engage in competitive depreciation as a means of stimulating exports. So far nothing of the kind, and indeed perhaps the very opposite, has happened. Faced with strong demand for exports, and with domestic inflation, most countries have had a motive to keep the value of their currencies high. That holds down the price of imports and helps restrain domestic inflation. Downward fluctuations of the dollar, such as occurred in the middle of 1973 and in the early months of this year, must in the light of this nexus be regarded as harmful to our efforts to curb inflation in the U.S. Of course one cannot anticipate that national preferences as regards exchange rates will always be the same and will always favor a high rather than a low value for the local currency. If demand in international trade should slacken, or if some countries should begin to make strong efforts to eliminate their oil deficits, national preferences and the trend of foreign exchange rates may change.

It is of considerable interest, therefore, that as part of the effort to reform the international monetary system, certain guidelines for floating rates have been proposed. The reform effort has met with only limited success, which was to be expected once skyrocketing oil prices and universal inflation engulfed the world. No long-run reform has been agreed upon, although valuable preparatory work has been done. But among the immediate steps that were agreed upon by the Committee of Twenty of the International Monetary Fund, the proposal establishing guidelines for floating provides some hope that extreme and inappropriate rate fluctuations can be contained.

The recent stability of the dollar in the exchange market, within a context of floating rates, indicates that the net movement of capital to the United States has increased sufficiently to just about offset the deterioration in our balance on goods and services. Unfortunately, we do not yet have actual data in detail to support this inference, but certain patterns were showing up earlier. In the first quarter, U.S. direct investors' net outflows were quite low, while there was a very large inflow of capital from foreign business concerns acquiring businesses in the United States. This pattern of direct investment may well be continuing. Portfolio investments involving international dealings in securities seem to have dropped off sharply this year, with Americans buying only a small volume of foreign securities even though the Interest Equalization Tax on such purchases has been dropped, while foreign purchases of U.S. corporate stocks -- an important type of inflow in the past few years -- has also paused. Moreover, new issues of bonds in the international markets outside the United States have been less this year than in any recent year.

By contrast, there has been an extraordinary surge so far this year in international capital flows through banks in both directions -- we see it in our own data and also in terms of new loans arranged in the Eurodollar market. U.S. banks, including the U.S. agencies and branches of foreign banks, increased their foreign assets by about $9 billion in the first five months of this year, spread over many countries but especially directed toward Japan. A simultaneous massive rise in liabilities reduced the net outflow

-- which measures the net impact on our international balance and on our domestic credit markets -- to only about $1-1/2 billion.

I would associate part of the increased international activity of U.S. banks with the removal or reduction of barriers to such transactions that occurred both here and abroad early in the year. At times, differences in relative interest rates have also been important, with U.S. rates moving up relative to foreign rates after the early part of the year. But I believe much of the heightened activity was a result of the new oil situation, which generated a demand for loans by some countries to help meet the higher costs, and at the same time resulted in an added supply of liquid loanable funds in international markets as OPEC countries placed their revenues with the Eurobanks.

In examining these manifold flows of capital, it must of course be borne in mind that an inflow or outflow of funds does not ordinarily influence the amount of bank reserves in the U.S. banking system or the American money supply. Foreign capital does not bring any new dollars from abroad. Every dollar of foreign capital "flowing" to the U.S. was in fact in the U.S. before. It simply shifted ownership. This shift could have taken the form of an American selling dollars to the foreigner, in which case the inflow was matched by an outflow as the American acquired whatever foreign currency or assets the buyer paid him with. Or it could have represented a shift among foreign holders, for instance if the foreigner acquired dollars from a foreign central bank which had held them previously as part of its reserves. What changes as a result of changes in capital flows, under our present regime of flexible exchange rates, is the exchange rate, as a rise in the demand for dollars, in the case of capital inflows, or in the supply in case of outflows, shifts the balance of the market in favor or against the dollar. Only in special cases is a different interpretation appropriate.

One further conclusion that I would draw from the variety of offsetting capital flows that have occurred is that under today's conditions, capital is highly mobile. The world's national money and credit markets are more open to shifts among countries -- sometimes via the Euro-markets, than they have been since before the 1930's. Hence the system of national and international capital markets constitutes in effect something like a large and only moderately compartmentalized pool, rather than many separate watertight compartments. As a result, any move of capital in one direction is quite likely to be offset by movements in the opposite direction. A large outflow from the United States tends to drive down interest rates abroad, which makes American capital markets relatively more attractive and causes other funds to come to the U.S., and inversely. To pour capital, whether owned by OPEC countries or others, into any one part of this market does not mean that the net supply in that market is increased by the full amount. Capital already present there tends to be pushed elsewhere, thus tending to even up the supply elsewhere. Of course, these equalizing movements will take place only if conditions are otherwise propitious. When there are heavy risks of a credit, exchange, or political sort, the movements will not occur, or will occur only in response to severe declines of exchange rates or increases in interest rates, or both. The evidence that in today's markets capital is highly mobile should be kept in mind in examining the possible effects of placement of OPEC money in any one particular market.

This leads me to some comments on the more specific aspects of the flows of funds derived from OPEC revenues, and their impact on financial institutions and structures. I believe it is worth emphasizing that there will be great disparities among the OPEC countries in their ability to utilize this new wealth to improve their own countries, and in their plans for investment of this huge cash flow in foreign capital markets. We see already that Iran has made plans for industrialization and is developing ties with countries that can be helpful in that process. We know that Kuwait, for instance, has been thinking through the requirements of an acceptable investment portfolio for some time, and is probably fairly well diversified. In the case of Saudi Arabia, the initial reaction, which was simply to let funds accumulate in liquid forms in the Eurodollar market, seems to be moving already in the direction of finding more permanent lodging in such investments, perhaps, as special issues of U.S. Treasury obligations. According to IMF data, the reported increase in monetary reserves of the OPEC countries in the first half of 1974 was about $15 billion, but the gains were accelerating, and were $3-4 billion per month in May and June, with larger increases still to come.

These funds should not be regarded as a monolithic mass of maneuver, poised to shift this way or that for speculative or political reasons. There are many individual OPEC governments involved and there is no evidence that they are taking any unnecessary risks with their funds. Working with their financial advisers, these countries are likely to distribute their funds over a wide range of investments, always mindful of the need for security and stability. In return for continued rising levels of oil output in OPEC countries, those countries understandably wish to be provided with suitable ways of holding their accumulating assets. I doubt that there will be attempts to attain dominance over particular large companies or economic sectors in the industrial countries, since this would expose them to considerable economic and political risks. At the same time, the amounts involved are formidable by any normal standards of international capital flows. Questions naturally arise about the ability of capital markets to absorb such flows without suffering severe dislocations. I believe some of these concerns are justified, but that others are exaggerated.

There are a number of ways in which an annual flow of funds of, say, $50 billion can be compared with over-all flows of funds in financial markets. In the United States alone the total of funds raised by nonfinancial sectors in U.S. credit markets are now close to $200 billion a year; for all industrial countries together the total is two to three times that amount. By far the greater part of these flows of funds is between domestic sectors of the economy, though at times the flow of funds vis-a-vis other countries can have a significant effect on capital markets in individual countries. Also, in recent years the Euro-currency markets have grown in importance as a mechanism through which funds move to and from national money and credit markets. The Euro-markets have now taken on increased importance, since a large part of the receipts of the OPEC countries is being deposited in their accounts in these banks, and in turn will be loaned by this group of banks to borrowers in national markets. The record shows that the Euro-currency market has been capable of very rapid growth in the past. For instance, the net size of the Euro-currency market (that is, after eliminating claims of one bank on another within the eight countries usually considered as forming "the market") grew by $25 billion in 1972 and by $50 billion in 1973. There is an estimate that a further net growth of $30 billion has occurred this year to mid-May, bringing the net size of the market to about $185 billion.

It seems to me that if we have problems in handling the flows of funds associated with higher payments for oil, it will not be so much because of the sheer size of the amounts involved, but because of several kinds of potential dislocations.

In the first place, the normal stream of investment into financial assets in a given country will reflect the existing asset preferences of investors and institutions in those countries -- a mixture of corporate debt and equity, financing of government at various levels, mortgages, and deposits in financial institutions. On the other hand, the investment preferences of OPEC governments may be quite different; I would expect them to be more interested in assets that are relatively liquid, widely traded both nationally and internationally, and backed by the strongest guarantees. That would imply some shifts in the yields on different kinds of financial assets in national markets, reducing yields on more liquid assets relative to yields on, say, mortgages. In the case of the United States, if there should be a large inflow to major U.S. banks and to Treasury obligations, as seems possible, some downward pressure may result on yields in those sectors. That does not mean necessarily that the rate of growth of the monetary aggregates will be significantly affected, but it does mean that yield relationships could be changed for some time to come. The Federal Reserve could establish and maintain any desired degree of over-all restraint or ease in monetary policy.

Another kind of irregularity in flows that could be troublesome is that OPEC countries are likely to prefer assets based directly or indirectly on the countries with the strongest economies and the broadest markets. So may the banks that receive OPEC deposits in the Eurodollar market and lend them out to governments and private borrowers all over the world. The problem of the weaker countries is obvious -- they will sooner or later find it difficult to attract funds from the market as their debt burdens reach the limits which the market should and probably will place on their borrowing capacity.

However, if they do not succeed in attracting funds to cover their deficits, it must be that some of the stronger countries are attracting more than enough funds to cover their own deficits with the OPEC countries. If a few countries with strong economies and broad capital markets attract a disproportionate share of OPEC investments -- and the United States could well be one of them -- a number of adjustments are possible. First, other countries needing to borrow to cover their deficits would be able to take advantage of the additional liquidity available in these surplus countries -- that is, capital markets in these countries could do a considerable part of the recycling job. Also, countries receiving inadequate financing could allow their currencies to depreciate, so that part of the adjustment could come through changes in the trade balance. After a point, however, these accommodations through the market mechanism would not take care of the problems of countries whose debt capacity was running out or who could not adjust their trade balance beyond some point of necessity.

To deal with such situations the most logical solution would clearly be for the responsible parties -- the OPEC countries -- to relieve the burden. The total amount of aid required would not be large relative to the mounting OPEC reserves, and it might be a more fruitful investment in terms of the stability of the world economy than a continuing accumulation of financial assets in the stronger countries. If the OPEC countries do not meet this challenge, should we expect those countries that receive OPEC funds in excess of their needs to act as financial intermediaries, borrowing from OPEC countries at market rates and with assurance that these assets of the OPEC countries are sound, while extending aid to cover the cost of oil to countries who cannot borrow at market terms? I raise this question not because I believe the industrial countries should cease to contribute to the economic progress of poorer countries -- quite the contrary -- but rather to emphasize that there is now a new burden on these countries that should call forth a new set of aid donors.

There has already been a considerable amount of activity by the OPEC countries that may ultimately relieve the burden for some of the LDC's, but though the list of proposals for new funds or institutions is quite long, it is not clear how well the actual disbursement of funds will meet the needs of particular countries. Nevertheless, if the OPEC countries are willing to do their share and the industrial countries are not left with an untenable intermediary position, we should be able to provide mechanisms for aiding countries when market sources are not available.

Finally, another aspect of the flow of petrodollars causing concern is the impact of these flows on the institutions in world financial markets. In particular, will untenable strains develop from a flood of OPEC funds coming in as very short-term liabilities for which banks must quickly find outlets that are usually much less liquid? It would be unwise to be complacent about this question -- bad judgments may be made and things can go wrong for individual banks. We must be prepared to meet these risks, by obtaining and providing up-to-date information, by careful regulation and supervision, and in the last resort by action that would safeguard the liquidity of markets and the integrity of the payments mechanism by keeping possible problems of any one institution from creating problems for the entire system. But given proper caution on all sides, I believe that fears sometimes expressed of financial difficulties are greatly exaggerated.

Banks and their OPEC customers have already begun to rationalize the flow of funds: there are reports that on the deposit side the maturities are stretching out, or yields are dropping enough to cause OPEC governments to seek out other assets; banks are assisting these countries to find more suitable outlets for their funds; on the asset side, some of the problem of liquidity is alleviated by the practice of making term loans whose interest rate can be adjusted at intervals to reflect changing conditions in the market. So far, it appears that the leading banks have dealt with these flows efficiently and relatively smoothly. Countries in need of funds have been able to raise very large sums in the Eurodollar markets -- anticipating their requirements for some time ahead. For instance, in the first half of this year, publicly announced medium- and long-term Eurocurrency bank credits totaled about $20 billion -- almost as much as in all of 1973 and far more than in any earlier year.

Nevertheless, to express faith in our financial institutions does not mean to say that they can meet any and all demands on them. On the contrary, if they are to act prudently, they will have to keep the scale and kind of their operations within the limits of acceptable risks. Given present oil prices, this may leave substantial investment needs of the oil exporters and borrowing needs of the importers to be met through other channels. There can be no assurance, at this time, that the problems particularly of the borrowing countries can be met without a substantial cut in the price of oil.

Whether the problems I have discussed relating to petro-dollars become acute or not depends in good part also on our ability to get control of inflation and generate more investment in the areas of greatest capacity shortages. If we can make progress on those fronts, we can be more hopeful that special problems of adjustment to high oil prices, or to other unexpected strains, will not degenerate into serious impasses.