Research Department
Federal Reserve
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Over a Barrel?

The past year's upsurge in oil import prices has helped push inflation rates around the world to historic levels, and in addition, has created serious trade-financing problems for oil-importing nations. Moreover, present evidence suggests that unless the consuming nations drastically reduce the growth rate of energy consumption and accelerate the development of domestic energy resources, they will become increasingly dependent upon unreliable Middle Eastern oil supplies. This increased dependency at today's stratospheric prices could subject them to "unmanageable" financial problems—in the words of Federal Reserve Chairman Arthur Burns—and could also render them vulnerable to further economic disruption in the event of a future embargo.

Arab squeeze

The increase in prices has reflected the vast change in relationships between the major international oil companies and the eleven members of the Organization of Petroleum Exporting Countries (OPEC). Beginning in 1970, the oil-producing nations began to impose a rapid succession of increases in "posted" prices—reference prices for calculating taxes and royalties. Initially, these increases were achieved ostensibly through negotiation, although the oil companies in actuality were forced to acquiesce or face possible expropriation of their concessions. But in October 1973, the last vestige of voluntarism was abandoned, when oil shipments to the United States were embargoed and posted prices increased unilaterally, boosting OPEC revenues from $1.80 to $7.00 per barrel.

Since that time, the producing governments have increased their revenue from taxes and royalties further, to a current figure of about $8.40 per barrel. In addition, they have acquired partial ownership of the oil concessions and, through "participation agreements" with the oil companies, have raised the price of "buy back" oil—the price the companies must pay to repurchase the host countries' newly acquired share of output. As a consequence of all these moves, the world market price of oil has increased four-fold in the past year.

The latest decision to increase revenues came at last month's OPEC meeting in Vienna, when the producers refused to rollback posted prices as had been hoped, but instead raised oil-company royalties by 33 cents per barrel. To set the stage for this move, the cartel nations had closed down about 17 percent (6.3 million barrels/day) of their crude oil production to offset a recent surplus of oil.

Fueling the inflation

The quadrupling of oil import prices undoubtedly has aggravated the worldwide problem of inflation. By this September, U.S. wholesale prices of fuels and related products had risen 64 percent above the year-ago level. Since petroleum is essential in the production of a wide range of manufactured goods and agricultural products, this cost

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increase has had a widespread impact on the national economy. By one estimate, the soaring cost of imported oil alone has accounted for about 2 percentage points of the 10-percent increase over the past year in the U.S. GNP price index.

The OPEC nations of course deny that the soaring price of oil has had a significant influence on worldwide inflation. They maintain that even at its present price, oil will account for no more than 1½ percent of the 14-percent inflation rate expected this year in the industrialized nations. Moreover, the producing countries argue that the pace of their industrial progress depends on the size of their oil revenues, and that a high level of prices is necessary to ensure the creation of viable and secure economies by the time their oil reserves disappear. They also assert that high oil prices today redress the injustices of the past, when prices of exported oil lagged behind those of imported food and manufactured goods. In fact, the price of oil has risen far more than that of any other commodity since 1970—and unlike the price increases in food and manufactured goods, the oil price hike has not reflected competitive market forces at work.

Financing the deficits

Whatever the merits of these arguments, there is little doubt that the soaring cost of imported oil has created severe balance-of-payments problems for the oil-importing nations, particularly the developing countries. According to U.S. Treasury estimates, OPEC nations can expect to receive $80 billion in revenues from their oil exports in 1974—compared with only $15 billion in 1972 and $25 billion in 1973—and another $5 billion from non-oil exports. But the oil-producing nations, many of which have sparse populations and undiversified economies, will be unable to increase imports sufficiently to compensate for the sharp increase in export receipts, at least in the short-run. Of the $85 billion expected this year, they are expected to spend only about $30 billion for goods and services, leaving export surpluses aggregating roughly $55 billion. The counterpart of these surpluses will be equally large deficits in the trade accounts of the oil importers.

The essential means for financing these deficits are at hand, since OPEC countries must invest their huge surpluses in some form—in the traditional capital markets of other countries, or the Eurocurrency market, or through international institutions. Indeed, those investments have been occurring since early this year. In the January-August period, according to Treasury estimates, the major oil exporters invested almost $28 billion of surplus revenues. Almost one-half went into Eurocurrency deposits in banks outside the U.S., largely in London. Another one-fourth went into U.S. government securities, commercial banks and real estate, and the remaining one-fourth into U.K. investments or in grants and loans to underdeveloped nations.

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Unfortunately, there is no assurance that the investments of the oil-exporting countries will match the distribution of the current-account deficits of the oil-importing countries. The wealthier countries with attractive capital markets and ample capacity to borrow will have little difficulty in financing a rising import bill. On the other hand, the lesser-developed countries and the less creditworthy industrialized nations will face serious difficulties.

A longer view

The longer that OPEC surpluses accumulate, even at present levels, the more difficult it will become for countries in a weaker financial position to borrow and incur a steadily growing volume of debt. Besides, if these surpluses were to widen, the burden of financing the oil-deficit might become "simply unmanageable," as Chairman Arthur Burns recently told the Congressional Joint Economic Committee. Such a situation could develop if world oil prices remained at current high levels, if consuming nations maintained their recent rates of growth in energy consumption and production, and if OPEC nations failed to expand their imports.

Walter Levy, the influential petroleum consultant, argues that the only way out of the dilemma is for the consuming nations to prevent their oil-dependency from increasing over this decade, by adopting conservation practices approaching austerity as well as developing their own indigenous resources to the maximum. According to his calculations, oil imports from the Middle East could be held constant over the 1972-80 period, at 18 million barrels/day, only if the annual growth rate of energy consumption in the non-Communist world were reduced from the 1968-72 annual average of 5.6 percent to the "austerity" level of 3.3 percent annually.

He argues further that greater efforts should be made to persuade the oil-producing nations to expand their purchases of capital and consumer goods, as well as their economic assistance to developing countries, sufficiently to offset the rising cost of oil exports. Many of the non-Arab OPEC countries with sizeable population—Indonesia, Iran, Nigeria and Venezuela—will have little difficulty in using their income for such purposes as their development programs are formulated. The Arab nations may well use the bulk of their increased earnings for building up the industrial and military foundations of their economies, as well as for expanded grant and investment programs.

In sum, it would appear that the main short-run problem involves **financing** the oil deficits, while the main long-run problem entails **adjusting** to the higher price of oil through reduced oil consumption. A practical problem confronting the consuming countries—especially those already in financial difficulties—is whether they should begin to adjust by reducing consumption today, or whether they should continue to import large volumes of oil by financing the deficits.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 10/9/74	Change from 10/2/74	Change from year ago Dollar	Change from year ago Percent
Loans (gross) adjusted and investments*	84,786	+1,515	+6,367	+ 8.12
Loans gross adjusted—	68,105	+1,398	+7,527	+ 12.43
Securities loans	2,630	+1,319	− 699	− 21.00
Commercial and industrial	24,069	+ 149	+3,605	+ 17.62
Real estate	19,912	+ 12	+2,240	+ 12.68
Consumer instalment	9,561	− 2	+ 683	+ 7.69
U.S. Treasury securities	4,143	+ 66	−1,324	− 24.22
Other Securities	12,538	+ 51	+ 164	+ 1.33
Deposits (less cash items)—total*	80,854	+ 18	+6,372	+ 8.56
Demand deposits adjusted	22,908	+ 559	+ 370	+ 1.64
U.S. Government deposits	293	− 417	− 158	− 35.03
Time deposits—total*	56,262	+ 2	+6,159	+ 12.29
Savings	17,916	+ 55	+ 249	+ 1.41
Other time I.P.C.	28,726	− 76	+5,422	+ 23.27
State and political subdivisions	6,234	+ 91	+ 170	+ 2.80
(Large negotiable CD's)	15,276	− 153	+3,580	+ 30.61

Weekly Averages of Daily Figures	Week ended 10/9/74	Week ended 10/2/74	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves	166	160r	43
Borrowings	63	132	113
Net free (+) / Net borrowed (−)	+ 103	+ 28r	− 70
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions Net purchases (+) / Net sales (−)	+ 760	+240	+278
Transactions: U.S. securities dealers Net loans (+) / Net borrowings (−)	+1,152	+938	+520

*Includes items not shown separately.

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