Research Department
Federal Reserve
Bank of
San Francisco

October 10, 1975

Beyond Recycling

Nearly two years have elapsed between the history-making events of late 1973, when the Organization of Petroleum Exporting Countries quadrupled the price of oil and embargoed shipments to the U.S., and the more prosaic events of September 1975, when the OPEC nations deliberated for a week before imposing a relatively modest (for them) increase in oil prices. In this situation, it would be useful to examine how well the consuming nations have been able to cope with this difficult problem, and how well the exporting nations have been able to cope with circumstances that normally would undermine any cartel.

Following the end of the embargo, developed and underdeveloped countries alike were left with enormous belance-of-payments dislocations induced by the oil price increase. To forestall competitive unilateral currency depreciations, import restrictions or excessive domestic restrictive policies, the major consuming nations first concentrated on the problem of financing the huge current account deficits created by the sudden OPEC actions. Financing mitigated—and postponed—the real transfers of resources stemming from the oil price increase.

Recycling experience

In the aggregate, the importing countries' current-account deficit has as its counterpart an equivalent current-account surplus of the exporting countries. Because this surplus must be invested somewhere, capital flows to oil-importing countries in the aggregate must necessarily balance their aggregate current-account deficit. As a practical matter, the bulk of OPEC's financial surplus must be invested in the world's principal money and capital markets, which are located in a comparatively few major oil-importing countries. For individual countries there are wide differences between the size of capital inflows and the size of current-account deficits.

The Euro-currency markets, which invested over one-third of OPEC's $60-billion surplus last year, performed reasonably well. The U.S. absorbed almost one-fifth of the total, and another one-fifth went into various investments in the U.K. and other developed countries. The other one-fourth of the $60-billion surplus represented OPEC investments in the obligations of international institutions such as the World Bank and the IMF, loans and grants to developing countries, and military assistance to Arab states. Commercial banks of the principal industrial countries played a major role in facilitating the flow of OPEC funds.

Despite this encouraging experience, there is some doubt that large-scale recycling through private money and capital markets can continue indefinitely. Some of the problems include: (1) the risks resulting from loan exposure in any one country, especially in view of the impaired debt-carrying

(continued on page 2)

Research Department
Federal Reserve
Bank of
San Francisco

Opinions expressed in this newsletter do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco, nor of the Board of Governors of the Federal Reserve System.

capacity caused by previous loans still outstanding; (2) the risks resulting from large concentrations of liabilities to a few depositors with similar response patterns and motives, and (3) the portfolio imbalances created by distorted relationships between maturities of assets and liabilities, with OPEC depositors prefering short-term liquid claims but borrowers requiring longer-term financing.

Because some countries might have difficulty in obtaining private financing, it has seemed imperative to expand various international financing schemes developed in the earlier stages of the oil crisis. For example, the International Monetary Fund expanded its special oil facility by SDR 5 billion (roughly $6 billion) and the Organization for Economic Cooperation and Development agreed to establish (subject to legislative ratification) a "solidarity fund" or "safety net" in the initial amount of SDR 20 billion, (about $25 billion).

OPEC surplus

These official arrangements will help to forestall oil-induced balance-of-payments crises in the immediate future. But how manageable will the deficits of oil-importing countries be over the longer term? Prospects of success would be improved if the oil exporters' cumulative investible surplus at the end of the current decade approximates the Treasury estimate of $195 billion (in 1974 prices) rather than the much higher figures estimated earlier.

The size of these surpluses depends (on the one hand) on the amount of OPEC oil revenues, investment income and other earnings, and (on the other hand) on the amount of OPEC goods-and-services imports plus financial-aid transfers. Oil revenues currently are being depressed by the world-wide recession and by consuming countries' conservation measures, but they should rise again as economic activity increases—provided the cartel price can be maintained. As for investment income, earnings on OPEC's already large, and still growing, accumulation of assets should increase rapidly. On the other hand, OPEC imports and financial grants will retard asset accumulation. OPEC imports in particular were surprisingly large last year—amounting to over one-third of their $60-billion surplus—because of the initiation of major development programs and the outlay of large sums for military hardware. However, there is some question how long this rate of imports can be sustained, because time is needed to make full use of such a massive inflow of resources.

Real economic costs

The success experienced thus far in recycling OPEC oil funds has drawn attention away from some basic problems stemming from the oil price increase. While recycling has eased the adjustment, it has forced the consuming nations to pile debt upon debt, except for relatively small amounts of grant aid. Debt repayment at some point will be due, including not only the sums borrowed but huge interest payments as well. These payments will have to take the form of real transfers embodying the heavy costs imposed by the higher import price of oil—costs payable in the form of a larger volume of exports of goods and services. Unless sufficient aid is forthcoming from the wealthier countries, especially the major oil exporters, repayment could impose a very severe burden on the poorest oil importers.

Prices and the cartel

A significant and early decline in the price of oil would ease the real transfer problem and help the oil-importing countries manage their current-account deficits. Within the present decade, large supplies of Alaskan and North Sea oil should become available, and new discoveries in Bolivia, China, Malaysia, Mexico and elsewhere may provide important additional supplies. Oil exploration and the development of other energy sources should be stimulated by the high price of oil.

Optimistic observers claim that we are seeing the emergence of conditions which typically lead to the collapse of cartels. Downward price pressures develop either from increased supplies—whether from outside sources or from the breaking of cartel agreements—or from a weakening of demand such as we've experienced this year. In either case, a cartel must progressively reduce output to maintain prices. Smaller producers are tempted to increase output, taking advantage of the price umbrella maintained by the dominant producer—which must then cut back its own production again to keep prices high. Historically, this process sooner or later results in the destruction of the cartel and a drop in prices. In this view, because price maintenance by the cartel usually results in additional sources of supply, prices may even fall below the level obtaining before the cartel was formed.

At times this year, OPEC has had nearly a third of its capacity shut down, and price-shaving by some members of the cartel has been reported even in the wake of the recent price boost. Indeed, the September meeting of OPEC ministers apparently was as much concerned with holding the cartel together as with raising prices in the face of the current worldwide glut. Continuation of downward pressures on cartel prices could make the recycling problem somewhat less frightening than it appeared to be a year or two ago. But this sanguine conclusion should receive an early test, as worldwide oil demand expands in line with a worldwide business recovery.

Ernest Olson

Research Department
Federal Reserve
Bank of
San Francisco
Alaska • Arizona • California • Hawaii
Idaho • Nevada • Oregon • Utah • Washington

FIRST CLASS MAIL
U.S. POSTAGE
PAID
PERMIT NO. 752
San Francisco, Calif.

BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 9/24/75	Change from 9/17/75	Change from year ago Dollar	 Percent
Loans (gross, adjusted) and investments*	85,559	– 393	+ 1,833	+ 2.19
Loans (gross, adjusted)—total	64,162	– 556	– 3,015	– 4.49
Security loans	1,016	– 697	– 564	– 35.70
Commercial and industrial	22,727	+ 33	– 1,426	– 5.90
Real estate	19,565	+ 4	– 350	– 1.76
Consumer instalment	10,039	+ 16	+ 314	+ 3.23
U.S. Treasury securities	8,811	+ 151	+ 4,836	+ 121.66
Other securities	12,586	+ 12	+ 12	+ 0.10
Deposits (less cash items)—total*	86,077	– 67	+ 5,460	+ 6.77
Demand deposits (adjusted)	23,779	– 466	+ 1,560	+ 7.02
U.S. Government deposits	315	– 300	– 587	– 65.08
Time deposits—total*	60,618	+ 687	+ 4,585	+ 8.18
States and political subdivisions	5,805	+ 15	– 196	– 3.27
Savings deposits	20,776	+ 22	+ 3,033	+ 17.09
Other time deposits‡	30,153	+ 508	+ 1,305	+ 4.52
Large negotiable CD's	16,397	+ 667	+ 839	+ 5.39

Weekly Averages of Daily Figures	Week ended 9/24/75	Week ended 9/17/75	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves	37	20	– 58
Borrowings	19	119	204
Net free (+) / Net borrowed (–)	+ 18	– 99	– 262
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+) / Net sales (–)	+ 981	+ 1,678	+ 520
Transactions of U.S. security dealers			
Net loans (+) / Net borrowings (–)	+ 668	+ 964	+ 945

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

Information on this and other publications can be obtained by calling or writing the Public Information Section, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 397-1137.