THE OIL CRISIS

AND

INTERNATIONAL ECONOMIC STABILITY

by

B. J. ROSS

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THE AGRICULTURAL ECONOMICS RESEARCH UNIT

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1. The Setting

The Economist of the 1st June, 1974 carried an article entitled "The Approaching Depression" with a sub-heading "The World's Rich Countries are Digging the Foundations for a Major World Depression."

When they read this some of my colleagues became a little perturbed and asked if I would analyse the article for them. I duly did so at a Seminar on the 18th June, 1974. This paper is based on the points made at the Seminar.

The article described initially why it was thought a depression was on the way and the points made were basically these:

(a) The Arabs quadrupling of oil prices has meant that a very large quantity of foreign exchange is to be transferred to the Arabs. However, if the Arabs do not spend their new incomes, then real resources in the form of tangible goods and services will not be transferred to them. At the moment the economies of the O.P.E.C. countries are not sufficiently developed to allow them to absorb the quantity of imports which would be bound up in the $50-60 billion which they will receive in oil revenues in 1974. The transfer of resources to the oil producing nations will only take place when they are capable of, and actually begin, spending their oil revenue. To the extent that the oil consuming nations, and the people in these countries, find that their money incomes are unchanged but their spending power is reduced because of the higher prices they are having to pay for oil, then real incomes will be reduced in the oil consuming countries. Thus the oil price rise is acting like a tax imposed by governments. The balance of payments surplus of the O.P.E.C. countries which could be in the region of $40 billion a year, represents spending power of that amount taken out of the Western economic system. The Economist says that a quick solution to this would be to reduce indirect taxes in the Western developed countries to offset the tax imposed by the Arabs. If the O.P.E.C. Countries were spending the whole of their increased revenue, real incomes in the Western countries would have to be reduced to free resources in the West to make them available to O.P.E.C.
At least, in this situation, all resources would be fully employed, but, on the other hand, if O.P.E.C. do not spend their revenue, spending power is reduced, and if that reduction in spending power is not offset then some resources in the West will be unemployed. The point being made by The Economist is they needn't be unemployed, and until there is a transfer of real resources to the O.P.E.C. Countries, and to the Arabs in particular, there is no need for real incomes in the West to be reduced.

The Economist's solution is obviously of a short term nature because it does not take account of what will happen when the O.P.E.C. countries do decide to cash in their reserves, but it does ensure that the Western world maintains production and incomes in the short term.

(b) The second point is the oil consuming world will have an enormous balance of payments deficit in excess of $40 billion. Now, this need not lead to a reduction in international liquidity, because the Arabs will need to invest their revenues and they will lend this money back, so that there will be no reduction in international money. The problem which will occur is that the oil producers will tend to invest their money in the strongest economies - they will lend funds to the United States and to West Germany, in particular. But, the biggest problems caused by higher oil prices will occur in countries like Japan, the United Kingdom and Italy. In other words, the problem associated with the re-cycling of capital from the O.P.E.C. countries to the oil consuming countries, until they manage to adjust to the higher prices, will be to ensure that the money made available by the O.P.E.C. countries is received by those which need it most, not just those in which the Arabs can get the highest returns on their funds.

(c) The third point made in the article is that dangers of an approaching slump are being disguised at the moment by the amount of stock building which is going on around the world. The economic boom experienced in all major industrial countries in 1973 and the later part of 1972 was such that stocks of all sorts of goods were run down all over the world. At the moment final demand for many types of goods is beginning to
slacken off and many businessmen are using the opportunity to replenish their stocks. Production is thus being maintained in the meantime, but production based on stock building cannot be maintained for very long.

(d) It appears that most of the finance ministries of the world are relatively optimistic. This in itself may be a danger because if they are optimistic they may not be making the contingency plans for an economic down-turn that they should be. One of the reasons for optimism is that each country thinks it is going to do better than its neighbours in world trade in the coming years, but this is obviously something which is impossible. The Economist describes the world's economic planners as "A generation of economic Winnie-the-Poohs following their own footsteps round and round a bush, convinced by the discovery of each new set of tracks that they are on the heels of countless whoozles and whizzles." Forecasters in each country begin from a universal belief in the continued growth of the volume of world trade, and a fast growth in manufactured exports at inflated current prices. Each country then assumes that it will increase its own share of world trade and thus be able to reduce its national trade deficit. As well as these trade forecasts all countries predict for themselves a high domestic growth rate, other forecasters then take these domestic growth estimates to confirm their own predictions about growing world trade and the Winnie-the-Pooh takes another turn around the bush. By these means the forecasters have convinced themselves that they have nothing to worry about.

(e) Until they become really apprehensive about the possibility of a slump most industrial countries will continue to be more concerned about their rates of inflation. Wage and price controls are largely believed to have failed and therefore governments are tending to turn back to deflation or restriction of demand to control inflation. Because of this many will be reluctant to stimulate demand to offset the effect of the higher oil prices.
This point made by The Economist has been emphasised by recent comments made by official spokesmen in both the United States and Germany, who have said that the industrial countries now have the chance of getting on top of inflation and must not throw away this chance by relaxing at this time. These are the two countries who will suffer least from the oil price increase. They are likely to run balance of payments surpluses or to come out about square this year. If they do not refl ate the problem is made that much more difficult for all the other western countries.

(f) The sixth point is that any single country which dared to step out of line and tried to do the right thing on its own would find that it very quickly ran a colossal balance of payments deficit. By refl ating internally and maintaining demand, imports would continue to pour in, but in other countries where such refl ationary measures had not been taken imports would be reduced by the general reduction in demand. The exports of the refl ating country therefore would fall at a time when its imports were being maintained, if not stimulated, and the balance of payments would show a very big deficit indeed. The article doesn't say so, but it is virtually implied that while no single country can do the right thing on its own, any single country can do the wrong thing and restrict demand and restrict imports. Many countries will say that "it is all very well maintaining the level of world demand but we have a special case. Our balance of payments deficit is such that we must take action." This sort of argument has been put forward in the United Kingdom, in Italy, in France. Some people are saying that New Zealand has a special case and should take action because of this. If all those in trouble consider themselves to be special cases, the wrong action will be taken. What the article says is that those countries which can most easily cure their balance of payments deficit are those which should not. In other words, strong countries like United States, West Germany, can come through easily. They can restrict demand either because they want to preserve their balance of payments surplus or to restrain inflation, but the more they succeed the more they push deficits on to other countries - the weaker nations who already have tremendous problems of their own.
(g) The seventh point is the rather sad one that any slump which does come will accelerate the decline in commodity prices which will hit most of all the poor countries which depend upon exports of rubber, cotton, copper, tin and so on. And of course, in general, a decline in commodity prices will also hit New Zealand, and particularly our wool exports. Just at a time when it seemed with last year's boom, that many of the developing nations were getting a boost which would enable them to make some real strides forward, it is sad to reflect that they are going to be knocked back, possibly more severely than they have been for a long time.

The article concluded, not unnaturally, that the forecasters should think again and that they should eliminate from their individual economic forecasts the growth they are assuming from a supposed rise in their net exports to other countries, whose own high forecasts of income growth spring from the assumption that they will also be increasing their net exports back to the first country.

2. Current problems:

It seems to me that the three outstanding problems facing the industrialised western world at the moment are:

(a) the size of the balance of payments deficits which countries are going to run in the current year,

(b) the possible reduction in the rate of growth of oil consuming countries, and

(c) inflation.

Of course these are all inter-related.
The joint balance of payments deficit which the western world will run this year of 40-50 billion dollars will be due to the oil prices and these will thus add to inflation. Action to curb the deficits in individual countries will restrict growth, but inflation is easier to live with when growth is rapid. The Japanese have lived with a rate of inflation higher than the rest of the industrialised world for a long time but people accept it relatively happily when everybody is getting better off. There is re-distribution going on with some people experiencing faster growth in their incomes than others, but everybody is gaining in absolute terms. But when you have no growth coupled with inflation, then the gains some people make from inflation are actually at the expense of a reduction in somebody else's standard of living. This is the situation which could be facing us, inflation and a falling off in growth. The political consequences of this situation are very marked. A further point is that any reduction in the rate of growth of the industrialised world now will make it much harder to meet the demand of the O.P.E.C. countries when they start to spend their accumulated reserves. We can expect that over the years their economies will develop; they will get to a stage where they can in fact spend all of their oil revenues and there will eventually come a time when they are spending more than they are actually receiving, and it is at that stage that we have got to be able to meet their demands with the transfer of real resources. The bigger our economies are at that stage the easier it will be to meet those demands.

3. Remedies:

What are we to do about the situation in which we find ourselves? Nobody has any definitive answers at this stage but we can make some suggestions.

(a) The first is very trite but it has to be said, and that is that we should really work hard at exporting as much as possible to the oil producers, both in the form of goods and services.
Things that we will be getting paid for - selling mutton in the case of New Zealand, or selling agricultural advice. To the extent that this sort of action will represent a transfer of real resources to the oil producers in the years ahead, sales of this nature will reduce our real incomes in the western world, but there are offsetting advantages. The reduction in incomes will be less than that which would follow a world-wide slump, and the danger of a slump will be reduced by reducing the size of the deficits which the western world will be accumulating. Even if there is a transfer in real income, all productive resources will be kept at work in order to supply the oil producing countries with the goods which they buy from us. In addition, the reduction in the growth of our debt with the O.P.E.C. countries now reduces the need for a massive transfer of real resources at some future date and prevents the build-up of huge purchasing power in their hands which could have consequences, psychological or real, for the western world.

There are probably several things we can do to help the Arabs and others spend their money as quickly as possible.

(i) We can offer every possible form of technical advice to help the O.P.E.C. countries develop their economies in order to increase their importing capacity as fast as possible. As their economies grow, as incomes rise, so will their demand for imports increase over the years, providing us with sales to match our purchases of oil.

(ii) We have got to allow Arab and other O.P.E.C. investment in Western countries. The recent purchase by Iran of a share in the Krupp steelmaking company is an example of investment of oil revenues in a western country. It is also an example of oil surplus funds going to one of the countries which is likely to show most growth in coming years and which is likely to have least need of oil revenues.
The Americans are talking of letting the Arabs invest in oil facilities in the U.S. - in oil refineries - in other words investing downstream in the oil industry. This is a start, but I think it will have to go a lot further than this. Of course it would suit us if the O.P.E.C. countries would hold their funds in U.S. dollars, lend us funds as we require them and let us repay the loans in U.S. dollars. Then if we let inflation go on, the purchasing power of the dollars would be reduced year by year, and when the accumulated reserves were eventually spent by the O.P.E.C. countries the transfer of real resources would be reduced by the amount of inflation which would have occurred over the years. The O.P.E.C. countries have, however, become aware of this possibility very quickly and they are keen to have their funds invested in inflation-proof forms of investment, and who can blame them for that? It is therefore likely that oil producers will want to invest in real estate and sound companies in selected western countries. To some extent we have got to let them do this, even if the level of share prices suggests that they could acquire some companies at bargain prices. There are two advantages for us; part of our debt is extinguished by the exchange of assets for oil funds, and secondly, to the extent that the oil producers obtain a financial stake in western countries they also acquire an interest in the economic well-being of those countries which could ultimately be to our advantage.

We should help the Arabs and others to spend the money that is being made available, either in the form of gifts, or loans to other developing countries. We have to help the developing countries to make the best use of the funds they get from the O.P.E.C. countries. To the extent that these funds are made available in the form of loans then, to some degree, the burden of debt is really simply being transferred from the developed to the less developed countries, and that is something which is to be regretted.
However, we should realise that loans for the developing countries from the high income countries are unlikely to be increasing as rapidly as the needs of the less developed countries in the coming years. Simply because the developed countries have balance of payments problems they will be less willing to make additional funds available to the less developed world. To this extent the O.P.E.C. loans will be substituting for loans from the U.S., Britain, France and elsewhere. In addition, I think we can say that to the extent that the spending of the loans granted to developing countries will help to keep the industrialised countries going, there will be some feedback to the less developed countries, in that the higher the rate of economic activity in the industrialised world, the higher will be the level of prices for the commodity exports.

One of the major problems facing a new donor of aid, with large sums to be disbursed, is the finding of sufficient worthwhile projects in which to invest. It may be that the biggest contribution the developed oil consuming nations could make at the moment lies in the field of seeking out, and investigating the feasibility of projects in the poorer, less developed countries. In this way the number of development schemes proposed to the potential donors could be increased, and if the funds were forthcoming there would be obvious benefits both to the developing countries who would be the initial recipients of the aid, and to the industrialised nations who could expect to provide some of the capital goods that development projects normally require.
(b) The next thing that we should do I think is to borrow now from the Arabs and the other O.P.E.C. countries at the rate which is required to maintain a reasonable flow of international trade and general economic activity in the years ahead. But we should use the next few years in which we are maintaining real incomes in the West to undertake some structural changes, firstly to reduce our dependence on the Arabs in the future, and secondly, to minimise the effect on real incomes when the O.P.E.C. countries do start to consume to the limits of their new incomes. Governments will be unwilling to pile up the hugh debts which may be required to maintain incomes if they see no prospect of their annual deficits being reduced in the future, and it therefore makes sense to use the borrowed funds in ways which do promise to reduce the deficits. We can, for example, greatly increase research and investment expenditures in areas which are likely either to reduce total energy needs, through more efficient use, or to provide alternatives to oil, by accelerating and increasing existing nuclear electricity programmes, research on nuclear fusion and the like, the development of alternative automobile fuels and the modernising of the ways in which fuels such as coal are used.

To minimise the effect on real incomes when O.P.E.C. spending is increased we need first of all to grow as fast as possible, to reduce the size of the required transfer relative to our G.N.P. at the time the transfer takes place. Secondly, we should aim to ensure that our economies are restructured in such a way as to make it possible to free resources for the production of extra exports without reducing the consumption levels of individuals in our societies. For example, we could start now in the industrialised world to consciously build up the level of our social and infra-structure capital. If we do this ahead of time and as it were ahead of need, then in the years when we do have to make a transfer of real resources to the Arabs, we could reduce our spending on schools, waterworks, roads and bridges, and free resources for making, for example, prefabricated buildings for O.P.E.C. countries. In this way it would be a diversion of public spending, and private spending in the hands of individuals need not be reduced at the time the transfer of real resources has to take place.
Politically this would make it very much easier to free the resources which will have to be made available to allow the transfer of real goods and services to the Arabs to take place. If we knew what the oil producing countries will want in the years ahead we could start investing now in the facilities to produce those particular goods. Unfortunately, of course we have very little idea as to which goods the Arabs will require in the mid-1980's. What we do know is that at that time we will have to be freeing resources to supply them with whatever it is that they want, and we should be planning now to restructure our economies in such a way that the transfer can be made in a manner which is as little disruptive of our economies as possible.

Historically the freeing of resources in this sort of fashion, usually for some purpose such as war, has been accompanied and accomplished by inflation, but now when we can plan ahead to the time when we will have to make such resources available, and when inflation is already a major problem, we should be able to manage our affairs in such a way that the inflation and possible instability associated with the transfer can be minimised.

(c) A further step we could take is the creation of additional international liquidity, in order to allow countries to run current account deficits in their balance of payments without having the full amount added to their overseas debts.

We are now in a situation where possibly 25-30 per cent of total international reserves could be transferred to the O.P.E.C. countries in one year. This money will be lent back to industrial countries, so there is no great need to create additional reserves to provide international liquidity as such, although it does appear from the way the reserves of some O.P.E.C. countries are building up that funds are not being recycled to industrial countries as fast as they might be.
The main reason for creating additional reserves at this time would be to give the industrial countries greater confidence to run deficits, the sorts of deficits they are going to have to run for longer periods, giving them time for structural change. These additional reserves could be created either by raising the price of gold or by a further issue of Special Drawing Rights. The official price of gold for transactions between countries is now well below the market price. The recent action taken when Italy was in rather desperate straits indicates that the Finance Ministers of the world are prepared to consider relaxations in the gold price and let the official price rise close to the market price and this is all to the good.

Some people have put the blame or at least part of the blame, for inflation in the last few years on the over-creation of S.D.R.s, giving too much international liquidity. It was therefore argued that further S.D.R.s at the moment would just make the world inflationary situation worse. But if we are talking about a situation in which internal demand in many industrialised countries is going to be deficient then additional demand created by more Drawing Rights would simply make up this deficiency and would therefore not be inflationary. To the extent that countries would be encouraged to go on running deficits because the deficits would be financed more from the running down of their new reserves than from the piling up of a debt against them in particular, the world could benefit from additional international liquidity at this time. The command over resources would accumulate in Arab hands just as rapidly as if they were lending us all the money back (though they may need to be reassured on this point by guarantees of purchasing power), but the continuation of growth which might be encouraged in this way would ease the payback at some later date.
The main point is that the O.P.E.C. countries are going to run substantial surpluses for some years to come. If the oil-consuming nations feel they cannot continue with the deficits implied by the O.P.E.C. surpluses, they may tend to curb economic activity in a way that could lead to a world-wide slump. The creation of more international money at this time will go some way towards reducing these tendencies. Since the developing countries would benefit more directly from the creation of S.D.R.s I would prefer this method of increasing liquidity, but an increase in the gold price will probably be obtained much more quickly, and of the two possibilities it certainly looks the more likely at the moment.

(d) We need greater international co-operation in the world and in the industrial world in particular. First of all, to channel the lending of the O.P.E.C. funds or the creation of S.D.R.s through the IMF to ensure that the additional money made available goes to where it can be of greatest use rather than simply to the U.S.A. and Germany which have in fact least need of this money.

We also need much greater co-operation in the co-ordination of fiscal policies by the major industrial countries, so that each one can plan its growth for the coming year knowing that its exports are not going to be unduly restricted by deflationary policies in its major export markets. There have already been meetings of the Finance Ministers of the O.E.C.D. countries and they have agreed that they will all run deficits of some sort or another in the coming year in the good cause of keeping the world economy going. But, The Economist comments on what they have agreed to so far as simply an agreement to jump out of the window without breaking any bones. In other words, they have not promised enough yet - just expressed pious hopes. They are not going to break any bones but they are still going to jump out of the window.
Finance ministers of the world are aware of the present problems but they are all acting as if each one of them was a special case, and that certainly applies to the United Kingdom, France, Italy and even to Germany, in a different way. The finance ministers are generally agreeing to cooperate, but continuing to act in their own best national interests as they see them.

4. Summary

We could have major problems approaching over the coming year or so, not just from the higher oil prices as such but from a deficiency in demand which they could create, coupled with widespread balance of payments deficits in the western world and continuing inflation.

And one country on its own can do only the wrong thing; that is, try to rectify its balance of payments deficits. To the extent that it succeeds, the problem will be made worse for others, as a further portion of our joint deficit is transferred from one country to the other countries.

No one country can do the right thing on its own; that is to stimulate demand to offset the reduction in purchasing power caused by the failure of the O.P.E.C. countries to spend their real incomes. Any country which tried to do this on its own, would have imports pouring in with no offsetting increase in exports, and the balance of payments deficits would become quite impossible to sustain. If some countries can do the wrong thing but none can do the right, the chances are that in the absence of international co-operation, the wrong thing will be done. What we need now is international financial co-operation on a scale not seen before, and a certain amount of public understanding that deficits, of at least moderate size, represent responsible economic management under present circumstances.
5. Epilogue

This paper has been so long appearing that some form of post-script seems to be called for, but the first thing to be said is that the delay has not brought to light any fundamental changes in the situation; rather one may say that some of the trends have become clearer.

Much of the equity investment of OPEC countries in industrialised economies has indeed been in economically strong countries, such as West Germany (which is now expected to show an external surplus of about $US8 billion for 1974), but there has also been significant investment in real estate in Great Britain. Probably as the result of a variety of historical and institutional reasons, the United Kingdom has received a surprisingly high share of the short-term deposit money; this has helped to maintain the value of the pound in the face of record current account deficits month by month. Whether or not this is a good thing depends on one's view of the relative benefits and costs for Britain which would result from further devaluation. One result of the increased demand for funds by the developed countries has been a sharp fall in the proportion of money borrowed on the Euromarket which has gone to developing countries.

Around the world levels of employment have held up very well, but changes in employment are notorious for lagging behind changes in levels of output, and many commentators now foresee substantial increases in unemployment in 1975. As expected, the American and West German governments have been reluctant to stimulate their economies in any way which could weaken their fight against inflation, but there are now signs that the Germans, at least, are about to take some positive action to stimulate economic activity. Economic growth throughout the 24 member countries of the Organisation for Economic Co-operation and Development (O.E.C.D.) is estimated as only one-quarter of one per cent for 1974, with not much more forecast for 1975. Reasons were advanced in the paper as to why such a cessation of growth should be regarded as undesirable, and another should be added to the list.
In Britain, at least, it appears that many of the large wage settlements now being made result from the determined efforts of workers to maintain or increase their real incomes at a time when the nation's real income is at best stagnant, and probably a little less than last year. In other words, it can be argued that the cessation of growth is itself a stimulus to inflation in countries where workers expect their real income to rise year by year, and where wage settlements are less tightly restrained by the authorities than in New Zealand.

A significant proportion of the oil funds have been deposited in short-term securities of various sorts, with maturities of less than a year. Whilst the reluctance of the O.P.E.C. depositors to lend long-term under the present unstable situation is fully understandable, the size of the funds potentially having to be repaid to a few creditors restricts the uses to which banks or governments can put the funds. Sharply increased differentials in the interest rates paid for short and long term deposits might persuade the oil producers to change their deposit policies. Failing this, banks could accept the short-term deposits for safe keeping only, with international liquidity being maintained by the compensatory creation of S.D.R.s. It is likely that some international credit creation will be desirable in any event as funds are not being recycled as fast as they are being accumulated. The benefits to be obtained from the success of the various schemes designed to persuade the oil producers to lend on a long term basis to the International Monetary Fund, or some new institution, which would then lend to the countries in greatest need, are undoubted, but it does seem unlikely that these schemes will succeed on the scale which is required.

One of the most disquieting things to emerge in the last three months of 1974 is the extent to which, publicly at least, countries such as the United Kingdom and France are still expecting to improve their situation in 1975 by a faster than normal expansion of their exports.
With the United States, the world's largest trading nation, showing no sign of significant growth in 1975, any hopes held by other nations, which are substantially based on expanding trade, are bound to remain unrealised.

Now, as before, it is obvious that our major hopes must rest on international co-operation which is effective in ensuring that the measures required to sustain the economic well-being of the developed and developing world are instituted quickly and decisively.