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Attached is an international economic review prepared by an interagency CIEP Work Group to serve as background for the February 11 Ministers' Conference.

Attachment: (1)

1. The Macro Economic Impact of the Oil Price Increase

A. Real Growth (Table 1)

Real growth forecasts for 1974 as a whole fall into two classes. The standard OECD assessment, as reported in Table 1, is that growth for the year as a whole in the major industrial economies will be substantially lower than had been expected prior to the oil crunch, but should begin to recover in the second half. The pessimistic assessment, which is the minority view, forecasts substantially lower growth rates for the year as a whole. Among the optimists and pessimists there is agreement that countries will face substantially lower growth rates in the first half than in the second half. The differences of opinion exist over what will happen in the second half of 1974.

The optimists expect economies to rebound by the second half of 1974 for the following reasons.

1. Monetary and fiscal policies are expected to become expansionary in the early part of 1974 in order to make up for the reduced aggregate demand caused by the oil price increases.

2. No permanent decline in overall consumer spending is expected--consumers will make a relatively rapid shift from high energe use items to low energy use items, reducing the high savings rates expected during early 1974.

3. Stronger investment demand is expected as relatively rapid structural shifts in each economy occur in response to higher fuel costs. Backlogs of unfilled orders and capacity shortages will stimulate investment demand.

4. World trade is expected to expand around 6-7 percent in value.

The pessimistic assessment is that the first half slowdown may continue, or perhaps even become worse, for the following reasons.

1. Monetary and fiscal policies have been aimed at fighting inflation and there is no evidence yet that monetary and fiscal policies are becoming sufficiently expansionary.

2. Industries hurt by the oil price increase can stop new investments immediately; industries which benefit may take longer than two or three quarters to expand their investment. In addition, overall uncertainty may lead other industries to postpone investments.

3. Growing unemployment may increase consumer uncertainty and thus slow down consumption expenditures.

4. World trade may be disrupted because of sharp exchange rate shifts and the possibility of import/export restrictions.

As Table 1 shows, the oil price increase affects countries very differently. Prior to the oil price increase, the United States was expecting a lower than normal growth rate because of cyclical factors. The original U.S. forecast was reduced to zero by the OECD in part because of the oil price increase and in part because of reevaluation of cyclical developments. With respect to the U.K., current labor problems are dominating the oil impact. The U.K. forecast in Table 1 assumes that labor problems will end by the beginning of the second quarter.

The OECD forecasts included in Table 1 and in the following tables are based on two general assumptions concerning oil supplies and prices:

1. OPEC prices will remain at the December 1973 level throughout 1974

2. at these prices and planned production levels, world oil markets will clear for the whole of 1974, i.e., at the going prices, there will not be any supply shortages except in very local situations.

Substantial changes in oil price levels or production targets would require a modification in the forecast.

TABLE 1

OECD 1974 ECONOMIC OUTLOOK

REAL GNP GROWTH

(Percent Change)

	OECD 1974 Total Year Original Forecast 1/	OECD 1974 Total Year Feb. 1 Forecast 2/	OECD 1974 First Half Feb. 1 Forecast	OECD 1974 Second Half Feb. 1 Forecast
United States 3/	2-1/4	0	-1-3/4	1-1/2
Canada	5-1/2	4-1/4	4	5
Japan	7-1/2	1-3/4	-1/2	5-1/2
France 4/	5-1/2	4-1/4	4	3-1/4
Germany	3-1/4	3/4	1	2-1/4
Italy	7-1/4	5	3	4
United Kingdom 4/	3-1/2	-2-1/2	-11 4/	+12-1/2
Total: (7 above)		1.0	-.75	+3.25

1/ Pre December oil price increase included

2/ Post December oil prices assumed to remain constant for the year

3/ CEA estimates are:

2.8% 1.0%

4/ Gross Domestic Product

B. Inflation (Table 2)

Inflation during 1974 will be substantially higher than originally expected. Price increases will be greatest during the first half as the oil price increases work their way through the system; the rate of price increase is expected to moderate during the second half.

Implicit in the OECD forecast is the assumption that in early 1974 monetary and fiscal policies will become more expansionary. If monetary policies remain restrictive, however, inflation may be lower than expected during most of 1974.

Implicit in the OECD inflation forecast is the assumption that wage increases will be substantial, but not explosive. Some forecasters believe that there is the possibility that inflation rates will be higher than projected by the OECD because of attempts by labor to not only make up lost income due to recent inflation rates, but to anticipate future overall price increases.

TABLE 2

1974 ECONOMIC OUTLOOK

GNP DEFLATOR

(Percent Change)

	OECD 1974 Total Year Original Forecast 1/	OECD 1974 Total Year Feb. 1 Forecast	OECD 1974 First Half Feb. 1 Forecast 2/	OECD 1974 Second Half Feb. 1 Forecast 2/
United States 3/	6-3/4	7-3/4	8-1/4	7-1/2
Canada	6-3/4	8	8-1/2	7-1/4
Japan	9-1/4	16-1/2	17.0	12-3/4
France 4/	7-3/4	12	13-3/4	11-1/2
Germany	7	7	7	6
Italy	10	11	10	13-1/2
United Kingdom	6-1/4	10-1/2	10	14

1/ Pre December oil price increase

2/ First half 1974 over last half 1973

3/ CEA forecasts are:

	6.0	7.2

4/ Gross Domestic Product price deflator

C. Current Account Balances (Table 3)

OECD forecast of current account balances incorporate increases in imports by the oil producers, but do not take into account the possible trade effects of recent exchange rate changes. Since the beginning of October, the currencies of the major European countries and Japan have depreciated with respect to the dollar between 10% and 15%. Even more startling, the dollar now stands at a higher value with respect to the pound, and lire than it did following the Smithsonian. (See Table 4).

It is impossible to anticipate prospective patterns of capital flows. The oil producing countries have little alternative to re-investing a large portion of their excess oil revenues in the industrial countries and the combined current account deficit of the latter will in this sense be financed by the reflows from the oil producers. However, the funds may not flow back automatically to individual countries in accordance with their needs, and measures may need to be considered to supplement market flows if unacceptable pressures on exchange rates and reserves (Table 5) are to be avoided.

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TABLE 3

CURRENT ACCOUNT BALANCE

(In billion of $)

	OECD 1974 Total Year Original Forecast 1/	OECD 1974 Total Year Feb. 1 Forecast	OECD 1974 First Half Feb. 1 Forecast	OECD 1974 Second Half Feb. 1 Forecast
United States	$5.0	-4.0	-2.5	-1.5
Canada	0	0	0	0
Japan	-.5	-7.5	-4.0	-3.5
France	-.8	-3.5	-2.0	-1.5
Germany	1.0	-1.0	0	-1.0
Italy	-1.4	-5.5	-3.0	-2.5
United Kingdom	-3.0	-8.0	-4.5	-3.5
Total OECD	2.25	-40.0	-21.0	-19.0

1/ Made before the December oil price increase

2/ CEA estimates:

6.0 -4.0

*NOTE: CURRENT ACCOUNT DEFINITION INCLUDES GOVERNMENT TRANSFERS

TABLE 4

Changes in

Various Exchange Rates for US Dollars

February 7, 1974

	% Change in Current Value of Dollar from Value at:		
	Smithsonian Agreement	March 19, 1973	October 5, 1973
Canada	-2.2	-2.2	-2.7
Japan	-3.6	14.7	11.6
West Germany	-14.2	-2.0	14.6
France	-0.7	11.0	18.9
United Kingdom	17.5	11.0	8.9
Italy	14.0	17.3	17.2

TABLE 5

TOTAL RESERVE ASSETS OF SELECTED OIL PRODUCING COUNTRIES
(December 31, 1973) In Billions of U.S. Dollars

	Value of Total Reserves	Value of Official Gold Assets
United States	$14.38	$11.65
Canada	5.76	.93
Japan	12.25	4.26
France	8.53	4.97
Germany	33.10	4.97
Italy	6.43	3.48
United Kingdom	6.48	.89

D. Unemployment (Table 6)

All developed countries will face increasing unemployment as real growth rates decline. Increases in unemployment for 1974 were expected prior to the oil price increase because of cyclical declines, and the oil crunch, in adding to that expected increase, will create special employment problems in specific sectors of most economies including such sectors as the auto industry and the recreation sector.

Increases in unemployment will also be accompanied by reduced hours. In some countries, such as Germany, increasing unemployment will create pressure on migrant workers to return to their native countries.

Higher unemployment rates will inevitably lead to an increase in domestic political pressures.

TABLE 6

Unemployment in Major Industrial Countries

	1973	Projected 1974	Increase
United States	4.8 %	5.5 %	+ .7
Canada	5.6	6.2	+ .6
Japan	1.0	2.0	+1
France	1.9	2.6	+ .7
Germany	1.3	2.2	+ .9
Italy	3.6	4.0	+ .4
United Kingdom	2.8	3.9	+1.1

E. Monetary and Fiscal Policy in Major OECD Nations

Monetary and fiscal policies remain highly restrictive in most of the OECD nations. West Germany is the only major country that has recently softened its position somewhat, but its policies still are relatively restrictive. France and Japan--viewing inflation as the most important policy concern--have further tightened their fiscal and monetary policies since the beginning of December 1973. Others are continuing relatively restrictive policies with the exception of Canada, which is the least affected by the oil situation. Although forecasters in all of the major OECD nations are aware of the large potential contractionary impact of the extraordinary rise in their oil import bills, most of them cite other concerns--inflation, balance of payments, and international competitive positions--as reasons why their countries would continue to follow restrictive demand management policies.

To summarize policies by country:

1. Germany is beginning to loosen its monetary and fiscal reins, after following very restrictive policies last year. The 11% tax on investment has been removed, depreciation has been liberalized, and incentives for housing investments have been granted. The Bundesbank has also slightly relaxed its tight monetary policy and is providing liquidity to hard-pressed firms.

2. France adopted several measures to cut demand in early December, primarily through tightening monetary policy, and accelerating some tax payments.

3. Japan in late December raised the discount rate and, in January, announced a 1974 budget considerably tighter than last year's.

4. The United Kingdom--in response to its labor problems and supply bottlenecks resulting from the reduced work-week has taken several steps to damp down demand since December. Expenditures have been cut, while monetary policy has been kept tight.

5. Italy began to shift to a less expansionary monetary policy towards the middle of 1973, and has continued to maintain this stance during 1974.

6. Canada is continuing moderately expansionary monetary and fiscal policies.

In real terms, money growth (M_1 deflated by the CPI) was negative in all of the six major countries last year. Only Japan and Italy had negative growth in total money supply in real terms, however. Even so, except in the U.K., real money growth grew less than GNP, and was generally restrictive.

TABLE 7

RECENT TRENDS IN REAL MONEY SUPPLY GROWTH RATES

(Deflated by the CPI)

MAJOR INDUSTRIAL COUNTRIES

November 1973/1972 (annual rate)

	M_1	M_2
UNITED STATES	6.4	9.0
CANADA	-.8	4.8
JAPAN	-7.9	-3.0
GERMANY	-8.1	4.7
FRANCE	-6.8	3.3
UNITED KINGDOM	-7.1	11.7
ITALY	-6.2	-4.7

SECTION II

THE IMPACT ON LDCs

II. Impact on LDCs

The cost of LDC oil imports will rise from $5.2 billion in 1973 to $13-15 billion in 1974. To give an idea of the relative importance of this increase, the increase would be:

1. equivalent to 28-35% of LDC official reverse holdings

2. about equal to the total official bilateral flows of assistance financing to the developing world in 1972 of $8.6 billion

3. equal to about one-eighth of the LDCs total exports

The projected current account deficit for non OPEC countries in 1974 is approximately $14 billion, up from about $4 billion in 1973. These estimates are based on the assumption that the 1974 volume of imports will remain constant at the 1973 level. Such a development would have serious adverse effects on LDC growth rates.

LDCs are highly dependent on oil for growth:

1. For LDCs in the Western Hemisphere, 74% of the energy comes from oil and for the Eastern Hemisphere LDCs' oil constitutes 58% of total energy consumption.

2. There is very little non-essential consumption, similar to that present in the developed world, which can be curtailed without appreciably reducing output.

3. There are limited technical and economic resources in the developing countries which can be employed in the development and utilization of alternative energy sources even in those cases where alternatives may exist in some limited form. Whereas the U.S. can shift at the margin between coal and oil and can devote large sums to further exploration and development of energy sources, the LDCs cannot.

LDCs will suffer an additional effect of the fuel shortage and oil price increases--limited supplies and higher prices for fertilizer. This will reduce needed agricultural production.

LDCs will suffer another effect because of growth rates in developed countries will decrease demand for imports from the LDCs.

(Not all LDCs will be affected in the same way. Table 6 ranks countries according to the relative impact of the oil crunch).

COUNTRIES RANKED BY EFFECT ON OIL IMPORT BILL

Countries Which are Major Losers

Korea	Chile
Philippines	Uruguay
India	Ethiopia
Sri Lanka	Kenya
Viet Nam	Sahel
Cambodia	Senegal

Countries Facing Significant Difficulties

Bangladesh	Morocco
Pakistan	Costa Rica
Turkey	Honduras
Thailand	Dominican Republic
Sudan	Jamaica
	Brazil

Boderline Countries

Argentina
Colombia
Mexico
Peru
Malaysia

SECTION III

IMPACT ON OIL PRODUCERS (TABLES 8 & 9)

III. Impact on Oil Producers (Tables 8 and 9)

Assuming prices remain at January levels for the remainder of the year, oil revenues flowing to producing nations will run approximately 95 billion dollars, roughly 3.5 times their level in 1973. Arab producers will receive over one half of this increase with Saudia Arabia showing the largest income gain.

Only a small portion of these revenues can be spent for foreign goods and services during 1974, even under liberal expenditure assumptions. For instance, in the case of Saudia Arabia, assuming a billion dollar transfer in grants-in-aid to other less affluent Arab nations (primarily Egypt) and a 20% growth in the import of goods and services, Saudia expenditures in 1974 would only run about 4 billion dollars. This represents only 24% of estimated increased revenues and only 18% of estimated totaled 1974 earnings.

Other oil producers will have similar absorptive difficulties during 1974, even those with a greater current need for oil earnings to finance their economic development or military programs. Normal delays in planning and decisionmaking make it almost impossible to spend all increases in revenue generated by the price hike during the current year. Because of these expenditure lags, all oil producing countries will show massive current account surpluses in 1974, as shown in Table 8.

Official reserve holdings of oil producing countries are not large by Western European standards at the present time. For example, the largest reserve balances of any OPEC country in December were held by Saudia Arabia, 3.7 billion (see Table 9). This compares with 6.4 for Italy, 8.5 for France, and over 33 billion for Germany. However, reserve levels of producer countries should increase dramatically during 1974 as a result of the large current account surpluses. (Table 8)

TABLE 8

OIL REVENUES, IMPORTS, AND CURRENT ACCOUNT BALANCES OF OIL PRODUCING COUNTRIES (PROJECTED 1974) BILLIONS $

COUNTRY	OIL REVENUE	IMPORTS 1/	CURRENT ACCOUNT BALANCE
TOTAL	94.7	30.2	67.4
ARAB	50.6	11.5	40.3
Saudia Arabia 2/	19.9	3.5	16.6
Kuwait	7.3	1.6	6.0
Libya	7.0	1.7	5.3
Algeria	3.4	1.8	2.1
Iraq	6.4	1.0	5.5
Other	6.6	1.9	4.8
NON-ARAB	44.1	18.7	27.1
Iran	18.5	5.9	13.1
Indonesia	4.1	2.3	1.9
Nigeria	7.9	4.0	4.7
Venezuela	10.6	4.0	6.9
Other	3.0	2.5	.5

1/ Also includes grants and other imports for all countries are assumed to have increased by 25% over 1973 estimated levels.

2/ Saudia Arabia estimate postulated on the basis of a 20% increase in emports plus 1 billion $ transfer of grants-in aid.

TABLE 9

PRESENT AND PROJECTED TOTAL RESERVE ASSETS OF OIL PRODUCERS

(DOLLAR DENOMINATED)

Country	Estimated Total Reserves End 1973 (Billions $)	Projected Reserves End 1974 1/ (Billions $)
Saudia Arabia	3.7	20.3
Kuwait	.5	6.5
Libya	2.1	7.4
Iraq	1.3	6.8
NON-ARAB		
Iran	1.2	14.3
Indonesia	.8	2.7
Nigeria	.6	5.3
Venezuela	2.4	9.3

1/ Projection assumes all projected increases in current account balances are accounted for by increases in official reserve holdings.