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CENTRAL INTELLIGENCE AGENCY
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31 December 1974

MEMORANDUM FOR: Mr. Sidney J. Zabludoff
Council on International
Economic Policy
Old Executive Office Building

SUBJECT : Contribution to CIEP Annual Report

1. Attached is the unclassified draft requested on oil pricing, producer revenues, and consumer oil import bills for the President's Annual Economic Report.

2. If you have any questions, please call

STAT [redacted]

As stated

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CONTRIBUTION TO CHAPTER OF CIEP ANNUAL REPORT ON PROBLEMS RAISED BY INCREASED OIL PRICES

The dramatic increase in oil prices dominated international economic developments during 1974. The average cost of a barrel of imported crude oil rose from about $2.00 in mid-1973 to over $10.00 by the end of 1974. This increase both added to inflationary pressures in oil consuming countries and contributed to the general economic downturn by eroding purchasing power.

EFFECTS IN DEVELOPED COUNTRIES

During the first half of 1974, wholesale prices in major OECD countries increased at an annual rate of over 30%. More than half of the increase was attributable to the direct and indirect effects of higher crude oil prices. Growing oil bills also accounted for about half of the nearly 15% rise in consumer prices during the period. Inflated consumer prices, in turn, led to increased wage demands. By the second half of 1974, higher labor costs were becoming an increasingly important factor sustaining the inflation.

Higher oil costs also depressed economic growth by shifting about $70 billion in purchasing power from developed countries to the oil exporting countries.

This drain, analogous to an increase in indirect taxes, came at a time when most major industrial countries were dampening demand to combat inflation. Thus, the hoped-for "soft landing" turned into economic stagnation. Throughout 1974, most industrialized countries continued to focus on inflation and did not combat contractionary tendencies by easing fiscal and monetary policies.

The aggregate trade balance of the developed countries which constitute the Organization for Economic Cooperation and Development (OECD) deteriorated from traditional surplus to a deficit in 1974 of some $30 billion. This represents a net change of $40 billion from 1973. A geographic breakdown shows that the aggregate OECD deficit was entirely due to higher oil costs. Although final statistics are not yet in, it appears that the OECD countries had a trade surplus with the LDCs of about $20 billion and a surplus with Communist nations of around $5 billion in 1974. Their trade deficit with OPEC countries totaled about $55 billion.

The plight of some industrial countries is even more serious than the $40 billion deterioration in the OECD deficit indicates because the distribution of the deficit is extremely skewed. Germany and Japan managed to offset the effect of the oil price increase on their trade accounts through aggressive export promotion. Japan recorded a small overall trade surplus over the past year while West Germany, offsetting sagging domestic demand with rapid export growth, achieved a surplus of nearly $19 billion. If the US, West Germany, and Japan are excluded, the deficit of remaining OECD members is on the order of $50 billion.

The United Kingdom, Italy, and smaller developed countries bore the brunt of the aggregate OECD deficit. The UK recorded a deficit of over $15 billion last year, about $8 billion of which was oil related. Italy, despite imposition of an import deposit scheme to discourage imports, finished the year with a trade deficit of about $9 billion. Nearly $7 billion of Italy's deficit was due to higher oil prices.

PROBLEMS OF THE LESS DEVELOPED COUNTRIES

Higher oil prices have created trade and payments problems for non-oil producing, less developed countries which will become even more serious over time. Throughout 1974, many LDCs were able to finance their higher oil bills through increased export earnings from primary commodities and by borrowing extensively in international markets. Others, however, did not share in the commodity boom and were not able to borrow. Even the richest non-oil producing LDCs are finding it increasingly difficult to borrow funds, as their credit lines are rapidly being depleted.

The economic slump in industrial countries and the tight food supply situation worldwide are compounding the problems of the LDCs. Decreased demand for primary products is already beginning to depress prices and foreign exchange earnings. Higher food prices are forcing the LDCs to spend a higher proportion of their export earnings just to feed their populations. These two factors are making it even more difficult for LDCs to pay their oil import bills. Without increased financial assistance, a number of LDCs will be in serious economic difficulty by the end of this year.

OPEC COUNTRIES' RECEIPTS AND EXPENDITURES IN 1974

Their huge oil earnings have given the oil producing nations literally more money than they can spend. OPEC's oil receipts in 1974 total about $94 billion, a more than threefold increase over 1973. Their spending also increased drastically. Preliminary trade returns indicate that the value of OPEC imports increased more than 70% in 1974 to a total of about $34 billion. This left the OPEC countries with an investable surplus of some $60 billion, the bulk of which was placed abroad in short-term bank deposits and government securities.

OPEC INVESTMENT PREFERENCES IMPEDE RECYCLING

One of the immediate problems is the pattern of oil producer investment, which has made recycling of oil revenues difficult. The foreign investment patterns of the oil producers are quite similar. In part, this reflects shared investment objectives, including:

- °Insuring their holdings against political seizure.
- °Maintaining -- or increasing -- the real value of their assets.
- °Retaining effective control of their investments.

The similarity is also due to the common environment for their investment deicison, including London's predominance as an international financial center, generally strong economic and political ties with London and Washington, a shortage of qualified personnel, and, most important, the depth of the dollar market.

OPEC investment is concentrated in financial markets in just a few developed countries. Most holdings -- perhaps 75%-80% of the total -- are dollar denominated. Eurodollar investments -- dollar assets outside the United States -- constitute the largest part of the investment portfolio, while dollar holdings in the United States are also sizeable and increasing in importance.

OPEC holdings are largely liquid assets, particularly bank deposits. While bank deposits generally do not pay the highest return, they are safe, easily managed, and can readily be channeled through intermediaries to provide the anonymity that makes seizure unlikely.

The oil producer preference for short-term deposits severely limits the ability of commercial banks to make long-term loan commitments. Thus, many developed countries such as Italy and the United Kindgom are financing trade deficits, which they can scarcely hope to eliminate soon, with short-term credit. This mismatch between the supply and demand for credit is an important aspect of the recycling problem and raises fears about the stability of the international financial and monetary systems.

POSSIBLE TRENDS IN OPEC EARNINGS AND INVESTABLE SURPLUS

Unless oil prices fall substantially, the OPEC countries will continue for some years to earn more than they can spend. If prices do not increase appreciably, OPEC oil exports will probably rise by about 1.5% in 1975 and level off in 1976 and 1977, when the increase in non-OPEC oil production will roughly equal the growth of world demand. Under these assumptions the earnings of oil producers would increase from $105 billion in 1974 to $112 billion in 1977. Should oil producers lower prices by 10% annually beginning in mid-1975, their earnings in the final year, after allowing for a resulting increase in world demand of about 2%, would be about $91 billion. Conversely, a 10% annual increase in prices beginning in mid-1975 would increase OPEC earnings to an estimated $135 billion in 1977, assuming a 2% drop in demand as a consequence of the price hike.

The value of OPEC imports will grow rapidly over the next three years although probably somewhat below the explosive 75% rate of 1974. Should OPEC imports increase by 50% this year and 30% and 20% in 1976 and 1977 respectively, aggregate OPEC imports would total nearly $80 billion in 1977. This projection assumes a declining rate of world inflation and takes into account the fact that many of the oil producers with the greatest capacity to increase imports such as Indonesia and Algeria will very quickly utilize the increased foreign exchange earnings.

Under the constant oil price scenario, OPEC's investable surplus would decline from $60 billion in 1974 to $33 billion in 1977. Should oil prices rise at a 10% annual rate the investable surplus would stabilize at about $70 billion over the next three years. A 10% annual reduction in oil prices would reduce the investable surplus to $22 billion by 1977.

PROJECTED CONSUMER OIL BILLS

The aggergate oil bill of consuming countries is expected to grow from about $121 billion in 1974 to $130 billion in 1977 if present prices are maintained. This figure includes oil imports from all foreign producers. Assuming that a 10% change in prices results in a 2% change in demand, the aggregate consumer bill could reach $154 billion in 1977 in the case of a 10% annual price increase or fall to $106 billion in the case of a 10% per year reduction.

(to be followed by Treasury Department section on the recycling problem)

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TABLE 1

PROJECTED OPEC OIL EARNINGS[1]

(BILLION $)

ASSUMING CONSTANT OIL PRICES

	1973	1974	1975	1976	1977
OPEC TOTAL	25.2	105.3	114.0	112.2	111.5
ALGERIA	1.0	4.1	3.6	3.6	3.6
ECUADOR	.1	.5	.5	.5	.5
INDONESIA	1.2	3.5	4.4	4.7	4.7
IRAN	4.5	20.3	21.7	21.7	21.7
IRAQ	1.7	5.8	7.5	6.7	6.7
KUWAIT	1.9	8.6	8.2	7.4	7.4
LIBYA	2.3	6.7	7.9	7.1	7.1
NIGERIA	2.4	8.7	9.2	9.2	9.2
QATAR	.4	1.9	2.0	2.4	2.4
SAUDI ARABIA	5.5	29.9	32.2	32.9	32.9
UNITED ARAB EMIRATES	1.2	6.6	8.1	8.1	8.1
VENEZUELA	3.0	8.7	8.7	7.9	7.2

ASSUMING A 10% ANNUAL INCREASE BEGINNING IN MID-1975

	1975	1976	1977
OPEC TOTAL	118.9	126.2	135.2

ASSUMING A 10% ANNUAL REDUCTION BEGINNING IN MID-1975

	1975	1976	1977
OPEC TOTAL	109.6	99.2	91.2

1. Actual receipts for oil exports will roughly equal accrued earnings in 1975-77. In 1974, actual receipts were $11 billion less than earnings because of the average lag of two months in payments by concessionaires to producers, which delayed the full impact of the 1 January 1974 price increase.

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TABLE 2

PROJECTED OPEC INVESTABLE SURPLUS 1975-77

ASSUMING CONSTANT OIL PRICES

	1975	1976	1977
Export Receipts	119.9	118.8	118.9
Oil	114.0	112.2	111.5
Non-Oil	5.9	6.6	7.4
Import Payments	-51.0	-66.3	-79.6
Net Services	-1.1	2.0	3.5
Investable Surplus	67.8	54.5	42.8

ASSUMING 10% ANNUAL REDUCTION

	1975	1976	1977
Export Receipts	115.5	105.8	100.5
Oil	109.6	99.2	93.1
Non-Oil	5.9	6.6	7.4
Import Payments (f.o.b.)	-51.0	-66.3	-79.6
Net Services	-1.4	.9	.7
Investable Surplus	63.1	40.4	21.6

ASSUMING 10% ANNUAL INCREASE

	1975	1976	1977
Export Receipts	124.8	132.8	142.6
Oil	118.9	126.2	135.2
Non-Oil	5.9	6.6	7.4
Import Payments (f.o.b.)	-51.0	-66.3	-79.6
Net Services	-.9	3.2	6.7
Investable Surplus	72.9	69.7	69.7

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TABLE 3

PROJECTED OIL IMPORTS
1973-1977

BILLION $

ASSUMING CONSTANT PRICES

	1973	1974	1975	1976	1977
TOTAL IMPORT VOLUME (MILLION B/D)	33.0	31.5	32.0	32.0	31.8
TOTAL VALUE	35.0	120.6	129.9	129.9	128.9
UNITED STATES	6.8	22.4	24.5	24.9	25.3
WESTERN EUROPE	16.6	55.0	57.6	55.4	53.2
JAPAN	5.9	19.2	20.3	21.8	22.6
CANADA	1.1	3.4	4.1	4.1	4.1
COMMUNIST	.5	2.0	2.6	3.0	3.0
OTHER	5.1	18.6	20.8	20.7	20.7
ASSUMING A 10% ANNUAL INCREASE IN OIL PRICES					
TOTAL IMPORT VOLUME			31.7	31.4	31.2
TOTAL VALUE			134.4	145.0	154.4
ASSUMING A 10% ANNUAL REDUCTION IN OIL PRICES					
TOTAL IMPORT VOLUME			32.3	33.0	33.7
TOTAL VALUE			125.1	115.2	106.6

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