EXECUTIVE SECRETARIAT

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Executive Secretary

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OFFICE OF THE SECRETARY OF THE TREASURY
WASHINGTON, D.C. 20220
January 28, 1983

UNCLASSIFIED
(With Secret Attachments)

MEMORANDUM FOR	OVP	- MR. PHILIP HUGHES
	STATE	- MR. L. PAUL BREMER, III
	OPD	- MR. LES DENEND
	NSC	- MR. MICHAEL O. WHEELER
	AGRICULTURE	- MR. RAYMOND LETT
	CIA	- [redacted]
	COMMERCE	- MRS. HELEN ROBBINS
	DEFENSE	- COL. JOHN STANFORD
	USTR	- MR. DENNIS WHITFIELD
	CEA	- MR. WILLIAM A. NISKANEN
	OMB	- MR. ALTON G. KEEL
	ENERGY	- MR. WILLIAM VITALE
	INTERIOR	- MR. J. ROBINSON WEST

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Subject Interagency Group on International Economic Policy (IG-IEP)

On Tuesday, February 1, 1983, at 11:00 a.m., Assistant Secretary Marc Leland will chair an IG-IEP meeting in Room 4121 in the Main Treasury building. The meeting is to discuss international oil prices. Attached, please find background papers for the discussion.

Please telephone the name of your representatives to the Executive Secretariat (566-2404) by noon, Monday, January 31. Attendance is limited to principal, plus one.

David E. Pickford
Executive Secretary

Attachment

UNCLASSIFIED
(With Secret Attachments)

Oil Price Study

1. Overview
2. Potential Impact on U.S. commercial banks
3. Effect of a Total Loss on Loans to Indonesia, Mexico, and Venezuela
4. Economic Impact on U.S.
5. Impact on World Macroeconomic Situation
6. Impact on Energy Industry and Energy Policy
7. Effects on the U.S. Energy Situation
8. Country Data and Immediate Impact of Oil Price Drop

Treasury/ICE
January 28, 1983

A Sharp Decline in Oil Prices

Overview

During the past several months, continual softening of oil prices has raised questions about the gains or losses that would result from a fall in world oil prices. Last weekend's OPEC disarray added to the timeliness of these questions. It has been argued that a decline in real oil prices should be avoided. It was argued that a decline in the real price would disrupt conservation efforts; reduce exploration; and diminish incentives for substituting energy sources -- with the view that this would diminish energy security. These arguments rested on the belief that earlier real oil price levels were appropriate in a long-term sense and that temporary declines from a rising trend should be avoided because the temporary gains would be outweighed by slower adjustment to the high real price. We would reject that premise because the dramatic increase in alternative supplies of both non-OPEC oil and substitute energy sources and evident market pressures for lower prices have shown that there was nothing magical about OPEC's ability to determine "correctly" an equilibrium level for real oil prices.

From an economic perspective the answer to the question "are lower oil prices good or bad?" is perfectly straightforward and clear. Unambiguously, the non-OPEC world economy would be better off with lower oil prices: real growth and employment would be higher; inflation would be lower; and LDC debt problems on average would be less severe. The non-OPEC world would enjoy more of its output and have to transfer less to OPEC. These are the macroeconomic effects.

There will, however, be problems. Any sudden sizeable change in the world economic environment can cause disruptions, change expectations, and require structural changes. Adjustment to substantially different economic conditions proceeds neither smoothly nor costlessly. Adjustment also takes time to occur fully.

In the short-run: (1) oil exporting LDCs already facing difficult debt situations would face worse financing problems; (2) for the banking system, there may be serious debt servicing problems for some loans -- both domestic and international. From a bank's perspective this has to be weighed against improvement in other loans in their portfolios. (3) Some industrial country oil producers would lose government revenue; and (4) specific energy sectors would suffer losses. Furthermore, the losers will be aware of their losses and can be expected to complain loudly; but consumers enjoying lower heating bills and cheaper gasoline may be less likely to express their appreciation to public officials. But the conclusion about (permanently) lower oil prices is that the U.S. is better off, as are most industrial countries; most LDCs and Eastern Europe; a few industrial countries (Canada, Norway, and the UK) will be worse off; OPEC will suffer income losses; and the USSR will face reduced hard currency earnings.

The gains are fairly clear cut: after an oil price decline to, say, $20 a barrel (a 40 percent drop) the results would be as follows (the effects are roughly linear, thus a drop of half as much, to $26 a barrel, would result in about half the effects described below):

1. Real growth: The U.S. growth rate would rise somewhat less than 1 percent by the end of the first year and about 1.5 percent after the second year following the price decline.

-- other industrial countries would see growth rise by 1 to 1.5 percent;

-- non-oil producing LDCs could increase real growth 2 to 2 1/2 percent.

2. Inflation: U.S. down 1.5 to 2.0 percent in the short-run and perhaps 2.5 percent after two years; others similar gains depending on the relative share of oil in their cost-of-living indices.

3. Oil import bills: The 1983 oil import bill for industrial countries will be reduced by $90-100 billion; (the U.S. import bill alone by roughly $22 billion or about 1.5 billion net of increased demand for oil imports due to lower prices).

   -- LDC oil import savings could reach $9 billion.

4. Current accounts:

   -- OECD total current account balance would swing into surplus (from -$18 billion to +$17 billion).

   -- LDC exports could rise about 3 percent in real terms. Their current account deficit could decline by $18 billion.

For the U.S. economy some industrial sectors would gain more than others; those using oil and other energy sources the most heavily as a direct input would gain the most. The gainers would include chemicals and fertilizers, steel, transportation (airlines, trucks), food processing, agriculture, automobile manufacturing, etc. Of course, all users of energy for heat and light would be gainers as well (hospitals, schools, retail sales, etc.).

Debt problems.

Debt problems.

LDC problems. The only less developed countries adversely affected from a drop in oil prices would be net oil exporters, particularly those already facing serious financial problems. Oil importing LDCs would have their debt servicing capacity strengthened. Of the 10 largest LDC debtors to commercial banks, only Mexico and Venezuela are oil exporters; the other eight large debtors would benefit from lower oil prices.

1. Mexico. If oil drops to $20 a barrel Mexico's loses roughly $9 billion in oil revenues which must be added to required net new bank borrowings (a drop to $25 would mean a loss of $5 billion). Mexico may be able to increase production and exports to offset part of this loss. To date authorities have not wanted to disrupt market conditins by pushing exports, but if the market becomes disorganized there is some scope for higher sales. In any event, the banks would have little choice but to grin and bear the new loan demands. Mexico would not likely go belly-up and declare default. A seperate paper is being prepared analyzing the possibilities of default for Mexico and others.
2. Venezuela. At current production and export levels, oil revenues would be roughly 7 billion at $20 a barrel and about $5 billion less at $25. Again, there is some scope for increased exports.

OPEC. All members would face a sharp drop in oil earnings -- a decline on the order of $100 billion (at $20). Such a drop could not realistically be covered by drawing down foreign exchange revenues or by undertaking new private market borrowings (banks would be very hesitant to make new energy related loans). Something like half of the revenue loss would have to be met by reduced imports.

Banking System. Considerable concern has been expressed about bank exposure in energy sector loans. The Comptroller's office believes too much has been generalized from the Penn Square example, where outright fraud affected the loan portfolio distribution.

Since early September, when we began focusing on the potential effects of a sharp drop in oil prices, the OCC has been reevaluating the potential exposure problems of energy sector loans. This ongoing reevaluation has led to sufficient concern that the OCC is now undertaking a "test case" study of an individual "typical" energy bank to determine the likely loan problems. Results should be available the week of January 24. As noted above, however, banks would be "forced" to increase their exposure in Mexico and Venezuela, and could not expect a corresponding rise in interest receipts. In the absence of service payments, there will more likely be more net lending with explicit rescheduling to these countries.

Commercial banks would see some outstanding loans reduced in quality (e.g. to LDCs -- (Mexico, Nigeria, Egypt, etc and to specific sectors -- oil developers, coal mining, etc) but would simultaneously see some outstanding loans increased in quality (to LDCs -- Brazil, Korea, Hong Kong etc and to sectors -- air

lines, shipping, steel, etc). So long as they have run relatively balanced loan portfolios, the winners and losers will tend to offset each other.

The elimination of OPEC's current account surplus will not reduce the banking system's lending capabilities. Money previously transferrred to OPEC to buy oil which OPEC then deposited with banks will be kept in the industrial world. It will still end up in the banking system. For example, suppose a U.S. public utility spends $10 on Saudi oil which the Saudis saved and deposited with Citibank, which then lent the $10 to Chile -- the classic recycling process. Now the utility cuts electric rates, and consumers deposit the $10 at First Chicago, which lends it in the Federal Funds market to Citibank. Citibank is still able to lend to Chile. There may be distributional effects among banks and countries, but the money will still be available for lending to creditworthy borrowers.

Industrial Country losers

Three industrial countries use earnings from domestic oil production as a major revenue source: Canada, Norway and the UK. The direct revenue losses to the British government -- before any offsetting policy change -- would be sizeable for the UK -- about 1.5 percent of GNP at a $20 oil price; and even greater for Norway -- about 5 percent of GNP. But these revenues are dollar denominated and part of the domestic currency loss could be offset by exchange rate depreciation. Neither country would face external debt problems as a result of the oil price decline. Canada is essentially in net balance on energy. Most federal revenue from

energy would be lost at a $20 oil price, but the federal deficit would rise (before adjustments and assuming the domestic price of oil were allowed to fall) only from about $30 billion to $32.5 billion, a revenue loss of less than 1 percent of GNP. Perhaps the principal effect would be to apply the coup de grace to an already faltering Canadian energy policy.

Sectoral Problems

Fuel producing sectors -- oil, gas, coal, -- could expect profit declines following a sharp decline in oil prices.

General

Perhaps the most difficult question is whether the oil price decline would be temporary or permanent. If the current glut is based solely on worldwide recession, economic recovery would quickly firm prices and we would move back to the earlier trend line growth of oil prices. If this were to be the case, the disruption and dislocations caused by the decline might outweigh the short-term benefits and should be avoided by imposing a tax on oil -- the revenues being used to reduce the budget deficit.

But if the decline reflects a combination of too high a real price, increased use of alternative energy sources and non-OPEC supplies, and general conservation regarding energy consumption -- which we generally regard to be the case -- then the decline will not be temporary and the gains it offers should not be resisted.

Implications for Banks of a Major Fall in Oil Prices

It is difficult to predict the exact form in which a fall in oil prices might affect the international financial system. In analyzing the potential impact on the international financial system, it is useful to construct a worst case scenario, in which a severe crisis affected the major banks operating in international markets. The attached table examines the impact of such a serious financial shock to the banking system; namely, that a heavily indebted oil producer is unwilling or unable to pay interest and that banks, in response to pressures from their auditors or regulators, set up reserves equal to 20 percent of their outstanding exposure to that country. Because the costs of funding non-performing assets and provisions to reserves are charged against the banks' pre-tax earnings, the after-tax impact on profits and capital depends on the marginal tax rate of the banks, which is roughly 50 percent.

The attached table presents the estimated impact on estimated aggregate earnings of the nihe largest U.S. banks of: (1) a loss in interest income or, and/or (2) creation of loan loss reserves against exposure to the three major borrowers amongst the oil producing countries (Indonesia, Mexico and Venezuela). The calculations show the effects of a severe crisis on the nine largest U.S. banks in the aggregate; the impact on some will be greater while less on others.

The calculations in the attached table indicate that the impact of Mexico's ceasing to service its debt would be to reduce the aggregate earnings of the nine largest U.S. banks by about two-thirds, while the impact of a similar scenario for

Venezuela would reduce the earnings of this set of banks by about one-third; the effect of Indonesia imposing a moratorium would be barely noticeable. Were all three countries to simultaneously cease servicing their debt, earnings for this group would be wiped out. While in the aggregate the nine largest U.S. banks could absorb even such cataclysmic shock, it is likely that those with poor earnings and relatively large exposure could experience losses. Aggregate (pre-tax) loan loss reserves of about $3 1/2 billion as of September 1982 would provide a second line of defense. Finally, the capital of these nine banks was about $25 billion, so that even a total loss on all loans to all three countries would, after taxes, consume little more than a third of their equity.

The impact of a fall in oil prices on smaller U.S. banks and non-banks is a bit more difficult to estimate. The exposure of smaller U.S. banks to these countries tends on average to be less in relation to capital and to earnings than at the largest U.S. banks. However, there are cases where individual second-tier U.S. banks have very large exposures to particular countries, so a specific crisis could affect some individual smaller U.S. banks more severely. In general, the problems for smaller U.S. banks would be less severe.

Since the estimated exposure of non-U.S. banks to Latin America relative to their size tends to be less than the exposure of U.S. banks, they would be relatively less affected by any problems, although again individual non-U.S. banks have large exposures to particular developing countries.

The conclusion from this exercise is that a serious problem on the part of Mexico -- far more serious than anything we have seen so far -- could hurt but not destroy the profitability of the largest U.S. banks. By themselves, crises in Indonesia and Venezuela would have a perceptible but not critical impact on bank profits; in conjunction with Mexico, they would eliminate bank profits but not undermine the financial integrity of the banking system.

Perhaps most important, our anlaysis suggests that continued difficulties in debt servicing by these countries, similar to those they have experienced in the past, would have a substantial impact neither on bank profitability nor on the international financial system.

Impact of Default Scenario on Nine Largest U.S. Banks
(millions of dollars)

Country	Actual Exposure: June 1982 [1]	Estimated After-tax Impact of Loss of One Year's Interest [2]		Estimated After-tax Impact of Requirement to Reserve 20 Percent of Exposure		Estimated Impact on Both Loss of Interest and Requirement to Reserve	
		Amount	Percent of Earnings	Amount	Percent of Earnings	Amount	Percent of Earnings
Indonesia	1,900	105	3.2	190	5.8	295	9.0
Mexico	13,600	750	23.1	1,360	41.8	2,110	64.9
Venezuela	7,150	395	12.2	715	22.0	1,110	34.2
Total	22,650	1,250	38.5	2,265	69.6	3,515	108.1

1/ Exposure at year-end 1982 is presumed not to be significantly greater, given developments in international bank lending.

2/ Estimate based on 11 percent interest rates charged to borrowers and 50 percent marginal tax rate. Earnings for nine U.S. banks based on estimates of earnings per share by Salomon Brothers as of December, 1982. Total estimated 1983 earnings for nine banks is $3,250 million.

A possible concern that may arise if the world market price of oil drops sharply to $20 or $25 a barrel is the effect that such a price drop could have on the petrodollar holdings in the United States of the major oil producing countries. This concern, however, is unwarranted.

Assume that a major oil producer, such as Saudi Arabia, has an account at a U.S. bank. Many of the payments by U.S. producers for oil purchased from the Saudis have been deposited in this U.S. bank account. These funds, therefore, have never left the United States.

If the price of oil drops sharply, U.S. payments for oil purchases will also drop. The Saudis will receive fewer dollars to be deposited in their accounts. At the same time, U.S. oil consumers will retain more dollars which will remain in the consumers' U.S. bank accounts. Furthermore, instead of paying the Saudis for oil, U.S. consumers might buy autos and food or invest their funds. Their payments for such consumer and investment items would be deposited in the U.S. bank accounts of the sellers. Although the banks in which the various accounts are kept may not be the same, the funds continue to be a part of the U.S. money supply which, in the aggregate, the Federal Reserve can control. Thus, a sharp drop in the price of oil would not precipitate a financial crisis within the United States. Even if some dollars are transferred from one bank to another, this can easily be accommodated by the transfer of banks reserves via the Federal funds market within the banking system, or the sale of assets by one bank to another.

If the Saudis draw down existing accounts in U.S. banks in order to pay their debts as oil prices drop, the adjustment process also can easily be accommodated within the United States banking system. The Saudis would use their balances in their U.S. account to pay for U.S. goods and services. The payment process would simply involve the transfer of funds from one U.S. bank to another, leaving the money supply unchanged. Only the actions of the Federal Reserve can increase or decrease the money supply.

If the Saudis use some of their funds in U.S. banks to pay their debts abroad, this too should not have major ramifications. The foreign recipients of these funds presumably could use some of the funds to purchase U.S. goods and services. The funds, therefore, would find their way back into U.S. banks either directly or through the Eurodollar market.

The effect on the world banking system is similar. Funds paid by U.S. oil consumers over the years to oil producers have been deposited in U.S. bank or offshore Eurodollar accounts. The U.S. banks or Eurodollar market has then lent the funds around the world. If spending on oil declines, the funds will still exist in the U.S. or Eurodollar accounts of oil consumers, and are still available for lending around the world by U.S. and Eurodollar banks.