

Research Department
Federal Reserve
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January 11, 1980

OPEC: \$27? \$30? \$40?

The OPEC nations, all acting individually, last month sent a collective message to the industrial world that 1980, like 1979, would mean another year of inflationary price increases. To reinforce the point, most members—with the notable exception of Saudi Arabia—followed up their December price hikes with further increases in early January. Even if official prices remain stable for the remainder of 1980, the increase in average prices will exceed the 44-percent jump of 1979, which of course was exceeded only by the 1973-74 price upsurge. And if the world oil market is hit by another production cutback comparable to the 1979 Iranian cutback, the year-to-year gain could be double the 1979 increase.

The one bright spot in this otherwise dark outlook is the possibility that the worst already has happened. Barring a complete cutoff of all Iranian exports to the world market, sluggish world-wide demand resulting from brim-full inventories and a U.S. business slowdown could mean few (if any) further price increases over the course of the year. In that case, the overall increase in OPEC prices between the fourth quarter of 1979 and the fourth quarter of 1980 would probably range from about 13 to 28 percent, compared with the 82-percent increase that occurred between the fourth quarters of 1978 and 1979.

Historic event

Last year's upsurge in prices began with the shutdown associated with the Iranian Revolution—an event outweighed in magnitude only by the Arab oil embargo and price upsurge of 1973-74. For several months, Iran's normal supply of 5.5 million barrels a day (b/d) was completely lost to the world market without output elsewhere fully compensating for that decline in production. Even when Iran began producing again, it marketed only about half of its previous exports. Those supply pressures, plus the

frantic demand pressures exerted by refineries rebuilding their depleted inventories, culminated in a sharp increase in the average OPEC contract selling price, which had risen only from \$11.06 to \$12.93 a barrel between 1974 and 1978 (see chart). At OPEC's June 1979 meeting, the producers set a new ceiling price at \$23.50 a barrel, and even the "moderate" Saudis pushed their official sales price to \$18.00 a barrel.

Moreover, the price leapfrogging continued, climaxed in December by a new round of price hikes. First, Saudi Arabia raised its price for light marker crude by one-third, to \$24.00 a barrel, retroactive to November 1. By narrowing the differential between its price and the higher contract prices then being charged by the more militant producers (the "hawks"), the Saudis hoped to establish the basis for a more unified price structure at the forthcoming December 17 OPEC conference in Caracas. Other moderates—Venezuela, Qatar, and the United Arab Emirates—quickly supported that effort by moving into line with the Saudi marker price.

That unification effort failed, however, as Iran and Libya independently raised their official prices at the Caracas meeting, and then again on January 1, to new highs of about \$35.00 a barrel. With Saudi Arabia still at \$24.00, and other producers strung out in between, the average contract price for the first quarter of 1980 has reached \$27.00—more than double the late 1978 pre-Iranian Revolution average price—and it will rise even more if Saudi Arabia decides again to narrow the differential between itself and other producers.

Wanted: real increase

The desired strategy of the OPEC producers in 1980—at least the strategy of the hawks—will be to reduce production sufficiently to achieve a price increase in real terms, that

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is, relative to the dollar cost of their imports. They complain that the real selling price of their oil dropped 19 percent between 1974 and 1978, despite a 17-percent increase in nominal terms, because inflation in the industrialized countries and the decline in the exchange value of the dollar raised the price of their imports from industrial nations by an even greater amount. In terms of real purchasing power, their oil price did not return to the 1974 level until the third quarter of 1979.

With this strategy in mind—and assuming stable non-Communist world petroleum consumption—we can discern three possible price scenarios involving three alternative levels of OPEC crude production. Scenario I assumes that the level of OPEC production declines by less than 1.0 million b/d in 1980, which brings about a 13-percent increase in average nominal OPEC prices between the fourth quarter of 1979 and the fourth quarter of 1980. If OPEC import prices rise 10 percent, that would result in a real increase to the OPEC members of 3 percent. Scenario II assumes a greater OPEC production cutback of 1.0-1.5 million b/d, bringing about an average price increase of 28 percent in nominal terms, and 18 percent in terms of real purchasing power, over the same time-span. Scenario III, in contrast, assumes a production cutback of around 3.0 million b/d of at least several months' duration. A production cutback of that magnitude would be similar to that which accompanied the Iranian cutback of early 1979, and would probably have similarly severe price consequences.

Likely outcome

Currently, Scenario II appears to be the most likely outcome, with its assumptions of stable worldwide consumption and an OPEC production cutback of no more than 1.5 million b/d. A projected decline in U.S.

oil-import consumption supports the no-growth assumption of non-Communist world consumption. Moreover, worldwide inventories of crude and refined products have now reached record levels and are straining available storage capacity, making unlikely any repetition of last year's massive upsurge in refinery inventory demand. On the other side of the equation, Iran's production has declined substantially since last fall, from 3.8 to 2.9 million b/d, primarily because of oil-field maintenance problems. However, other hawks apparently have not implemented their earlier threatened cutbacks, while Saudi Arabia has decided to maintain its present production of 9.5 million b/d at least through the first quarter of this year.

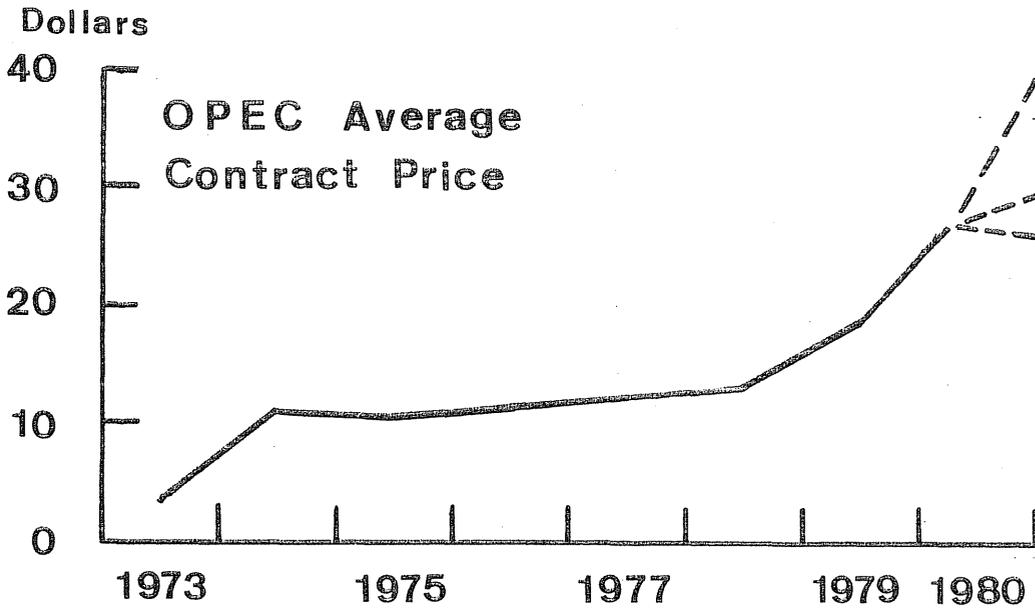
If this scenario materializes, the average OPEC contract price may rise only modestly over the remainder of the year, from a first-quarter level of \$27.00 to a fourth-quarter figure of \$30.00 per barrel. This moderate scenario gains some support from the recent behavior of spot-market prices for crude oil sales not under contract. Since November, with refinery inventories bulging, spot prices for light crudes on the key Rotterdam market have dropped from a peak of around \$42.00 to \$37.00 a barrel. Those prices could weaken further, in view of the present heavy inventory situation and consequent sluggish worldwide refinery demand, unless OPEC producers reduce output sufficiently to forestall a further buildup of crude inventories. But the OPEC nations could not agree on major production cutbacks during the 1974-75 recession, and they might not be able to discipline themselves enough to do so on this occasion either. In any event, a narrowing of the differential between spot and contract prices should help reduce the upward pressure on the latter, and help to moderate any further increases in contract prices over the remainder of 1980.

Effect on U.S. inflation

The behavior of OPEC prices will have a significant impact on the outlook for U.S. inflation. Rising world oil prices will directly affect the cost of both the 3.0 million b/d of imported oil and the 0.6 million b/d of uncontrolled domestic oil whose price moves in accordance with the OPEC price. The ultimate impact will involve both the direct effect of rising crude-oil prices and the indirect price effect on substitute fuels and products requiring fuel inputs. Congressional Budget Office analysts use a price multiplier of 1.3 to take account of these indirect effects.

The sharp upsurge in OPEC prices over the course of 1979 added about 2.0 percentage points to the rate of domestic inflation—measured by the GNP price index (deflator)—compared with the rate that otherwise would have prevailed with stable world oil prices. With the assumptions of Scenario II, rising world oil prices during 1980 could contribute 1.2 percentage points to the U.S. inflation rate. In the worse-case scenario—a repetition of the 1979 OPEC production cutback and price run-up—the domestic inflationary impact could be just as bad (if not worse) than we experienced last year.

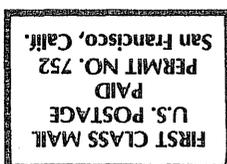
Yvonne Levy



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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 12/26/79	Change from 12/19/79	Change from year ago @	
			Dollar	Percent
Loans (gross, adjusted) and investments*	137,875	+1,397	+ 16,847	+ 13.92
Loans (gross, adjusted) — total#	115,051	+1,482	+ 16,697	+ 16.98
Commercial and industrial	32,372	+ 617	+ 3,925	+ 13.80
Real estate	43,123	+ 3	+ 8,727	+ 25.37
Loans to individuals	24,420	+ 191	NA	NA
Securities loans	1,623	- 34	NA	NA
U.S. Treasury securities*	7,249	+ 5	- 932	- 11.39
Other securities*	15,575	- 90	+ 1,082	+ 7.47
Demand deposits — total#	46,147	+1,015	+ 3,107	+ 7.22
Demand deposits — adjusted	33,718	+1,971	+ 3,178	+ 10.41
Savings deposits — total	28,398	- 134	- 1,811	- 5.99
Time deposits — total#	58,855	- 33	+ 7,940	+ 15.59
Individuals, part. & corp.	50,061	- 41	+ 8,592	+ 20.72
(Large negotiable CD's)	21,841	- 186	+ 1,626	+ 8.04
Weekly Averages of Daily Figures	Week ended 12/26/79	Week ended 12/19/79	Comparable year-ago period	
Member Bank Reserve Position				
Excess Reserves (+)/Deficiency (-)	36	- 30	- 15	
Borrowings	64	208	108	
Net free reserves (+)/Net borrowed(-)	- 28	- 239	- 123	
Federal Funds — Seven Large Banks				
Net interbank transactions	+1,784	+1,811	+ 694	
[Purchases (+)/Sales (-)]				
Net, U.S. Securities dealer transactions	- 21	- 79	+ 369	
[Loans (+)/Borrowings (-)]				

* Excludes trading account securities.

Includes items not shown separately.

@ Historical data are not strictly comparable due to changes in the reporting panel; however, adjustments have been applied to 1978 data to remove as much as possible the effects of the changes in coverage. In addition, for some items, historical data are not available due to definitional changes.

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