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Inflation, Recession, Oil, and International Financial Markets

by Paul A. Volcker

FINANCIAL markets—national or international—have in the past year or two absorbed a series of shocks virtually without precedent in a world at peace. The inflation gripping the industrialized world has had profound repercussions on balance sheets and financing patterns of businesses and banks. A world-wide boom has relapsed into the sharpest, and probably most prolonged, of our postwar recessions, providing a new test of the strength of our financial institutions. Sharply higher prices for energy have distorted international payments positions and posed large economic and political questions. In the face of these developments, plans for large-scale reform of international monetary arrangements have been shelved, and trade negotiations have gotten off to a slow start.

In these circumstances, one can understand if not be reassured by characteristics of the financial scene—distortions in credit markets, new peaks in interest rates for a time, new concerns over the soundness of some financial institutions and the international banking system generally, depressed equity prices, and sharply gyrating exchange rates. A sense of foreboding and malaise among the denizens of finance in London, Wall Street, and elsewhere at times became almost overpowering.

But it has been a boom year in one respect—there has been a ready market for those willing to try to offer some analysis and perspective, ranging from sensationalized "investment" advice on how to weather "doomsday" to scholarly reviews of the changing balance of world economic and political forces. Obviously, not all these analyses coincided. The torrent of words no doubt at times has contributed more to doubts than to reassurance. There are, to put it bluntly, many questions to which satisfactory and convincing answers are not yet apparent. Nevertheless, as time has passed, I think we can also detect a reassuring convergence of views on some of the major issues, most notably about the economic dimensions of the oil problem. The problem, severe as it is, does not inevitably lead to doomsday, and it is not beyond our collective capacity to manage the economic and financial consequences.

At the risk of going over some familiar ground, it may be worthwhile to try again to pin down the economic elements of the "oil problem" in the

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perspective of our dilemma of inflation and recession. In doing so, there is a risk of failing to emphasize sufficiently that, while the economic dimensions appear potentially manageable, some of the toughest problems and the greatest uncertainties are not narrowly economic.

In the foreground, there are strong political tensions in the Middle East. In the background, but perhaps as important, relations among the industrialized nations have themselves been in an unsettled state, contributing to a sense of impotence and disarray. On the surface, the prevalence of relatively weak and divided governments has been frequently noted—a particularly difficult situation when demands for international cooperation are high. Underneath, the gradual changes in relative national power positions, the gropings of the Common Market toward a greater unity, and marked differences among nations in the direct impact of the oil situation and their vulnerabilities to other external influences all tend to make international cohesion more difficult. In particular, the ability and willingness of the United States to assert and maintain a role as catalyst and leader—and other countries to either accept that role or provide an alternative—can be questioned. At the least, the challenge to maintain needed solidarity appears more difficult, and the diplomatic requirements for success more complex and subtle, than at any time in memory.

On top of the inherent difficulties of international cooperation, within some of the most developed countries of the Western world there is political disillusionment, increased social tension, and preoccupation with internal problems. The poor nations—once a rather passive element on the economic scene—now see their ambitious development plans threatened, just as they grow in political consciousness and strength on the world stage.

In this setting, we are forced to be realistic about what is possible, and what is not. We also need to appreciate the broader consequences of a failure to deal successfully with our major economic and financial problems. Effective action must rest, in turn, on some degree of understanding and consensus about the nature of the problem. Toward that end, it is useful to review the consequences of the higher oil prices in some detail, and to place that problem in the larger context of our inflation-recession dilemma at home and of other dimensions of international economic life.

The Oil Problem

In doing so, it is convenient to distinguish four aspects of the oil problem:

—the potential "real" impact on the standards of living and the growth of consuming countries;

—the balance of payments impact and the accumulation of international indebtedness;

—the problem of financial intermediation, or how the surplus revenues of the producers are to get redistributed; and

—the impact on purchasing power and prices, and its relationship to inflation and recession.

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All these aspects of the oil problem are related. All turn, in large part, on the price of crude oil. But separate analysis helps to establish appropriate priorities, and to ensure consistency in approach.

The Real Impact

The quadrupling of oil prices means additional annual revenues, at recent levels of oil exports, of some $80 billion for OPEC countries.[1] These additional revenues are a measure of the added command over the real resources of the rest of the world that the producing countries have potentially obtained from their action. Leaving out Eastern Bloc countries not dependent on OPEC oil, consuming countries currently have a Gross National Product of well over $3 trillion. Consequently, the potential transfer of resources amounts to less than 2½% of their GNP.

Some countries are hit harder than others. For the United States—a very heavy energy user, but importing only about 15% of its total consumption—the perhaps $20 billion annualized increase in import costs for oil implicit in current prices will amount to considerably less than 2% of its GNP. For Europe, the average has been estimated at over 2½%. For Japan and for some individual European countries almost totally dependent on imports, the figure is still higher.

Even assuming for a moment an unchanged real price for oil, these relationships will, of course, change as levels of oil imports rise or fall, and as economies grow. The full impact of the real transfer will be felt only over a period of years, for the OPEC countries are currently spending only a fraction of their new revenues.

On the other hand, an average citizen will feel a larger impact on his standard of living than the transfer of resources to OPEC countries alone would imply. The price of competitive sources of energy, whether produced domestically or abroad, is also rising. Consequently, there will be "transfers of resources" from energy consumers to producers within national economies, as well as abroad. The New Englander paying for energy, however, probably will not be consoled by the higher revenues for the state of Texas.

Attempts at precision in calculations like this would be fatuous. What we can say is that the "real impact" is certainly large enough to hurt—for the United States, it is something like a 7% tax increase (probably rather regressive in form) that provides nothing in return. But for relatively rich and industrialized societies, that is not in itself catastrophic. In general, the potential transfer of resources abroad appears to be in the order of magnitude of about one-half to two-thirds of a normal year's growth. While the level of real national income would eventually be set back by that amount, the growth rate of the economy would not necessarily be

1. For sources of these and other figures and estimates, see, for example, Hollis B. Chenery, "Restructuring the World Economy," Foreign Affairs, 53, no. 2 (January 1975), pp. 242–63 and Morgan Guaranty Trust Company, "Oil: Looking Back and Looking Ahead," World Financial Markets (January 1975), pp. 1–8.

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strongly affected. A recession, like the present, is much more costly in national income as long as it lasts. Moreover, given time, a developed country with a variety of exportable products—which means virtually all OECD countries at the least—would be capable of actually manufacturing and delivering to the OPEC countries goods and services in the required magnitude.

For some developing countries, the situation is much more serious. In the first place, the higher oil bill amounts to a larger percentage of their GNP, not because their oil imports are absolutely large, but because their GNP is so low. Consequently, already impoverished economies face the prospect of an even tighter squeeze. But the difficulties could extend beyond that implied by the arithmetic calculation. Opportunities for energy conservation are limited, and it may be much more difficult for those countries—perhaps impossible over a relevant period of time—to develop adequate export capabilities for actually transferring so large a portion of their income abroad. Potentially they can neither pay for the oil, nor operate their economies without it.

There are no apparent ways out of that dilemma aside from recognition of the need for essentially grant money. The amounts involved are not overwhelmingly large for the countries caught in that bind—perhaps on the order of $2 to $4 billion a year.[2] But amid the economic and political unsettlement in the rest of the world, finding that money presents perhaps the most difficult part of the problem. While these problems are not central to my theme, one can only point to the importance of the efforts underway—particularly in the framework of the new Development Committee established by the IMF and the World Bank to find new techniques for easing the load.

For most countries, conservation and development of alternate supplies can contribute substantially toward reducing the potential transfer of resources abroad by actually reducing imports. As responses to Mr. Ford's energy program indicate, we are rapidly learning that, since conservation and alternate supplies also entail additional costs at home, those actions do not eliminate the real burden. Indeed, they also complicate the task of coping with recession and inflation. For consuming countries, the only fully effective response to this economic problem lies in a lower price for oil. Even here, economics may conflict with concerns for national security and self-sufficiency, for cheap oil from abroad is a mixed blessing if it exposes a nation—particularly a nation with superpower status—to blackmail by embargo.

The Accumulation of International Indebtedness

The OPEC countries as a group will simply not be able fully to spend their added revenues for a number of years. Consequently, the *potential* transfer of real resources of which we have been speaking so far will not become an *actual* transfer for some time. In the meantime, the OPEC

2. See Chenery, "Restructuring the World Economy," op. cit., p. 262.

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countries will lend back to the consuming countries the revenues they do not spend.

We need not worry about whether the OPEC countries will choose to provide the rest of the world with capital or credit in some form. So long as they do not import goods or services equivalent to their revenues, they have no real choice in the matter. In practice, the payments to the producers do not usually leave the financial system of the West, even temporarily; rather there is a change in ownership of deposits or other financial assets from consumers to producers, or the creation of a new claim on a consuming country. A corollary is that, no matter how liquid the form of the financial assets acquired by OPEC countries, consuming countries *as a whole* will not need to repay their indebtedness until the producing countries import more than their current revenues—in other words, not until the consuming countries are themselves running a current account surplus. That surplus will, in turn, provide the wherewithal for repaying the debt—a process that will be spread out over many years.

Occasionally one sees calculations of the relationship between OPEC oil revenues and the existing international reserves of consuming countries, and of the growth portion of world reserves coming to be held by OPEC countries. The implication is drawn that this process must come to a grinding halt in the relatively near future. But these revenues of OPEC countries are lent back to consuming countries; their reserves *collectively* need not decline, despite the heavy oil payments.

In my judgment, we should not consider the accumulation of financial assets by the OPEC countries in the same light as the official monetary reserves of other countries, and record them in our statistics in the traditional manner. Those OPEC assets are functionally a transfer of their national wealth—their national patrimony if you will—from the form of oil in the ground into the form of financial claims on the rest of the world. In time, most of the OPEC countries will accumulate wealth in the form of other tangible and intangible assets at home such as manufacturing, transportation, better-educated citizens, and mastery of modern technology. As they do, their imports will rise, and Western nations will be able to repay the claims. Whatever their nominal form, most of the so-called reserves of the OPEC nations are more analogous to the long-term investments abroad held by U.S. corporations and citizens or the portfolio of common stocks held by the British government for many years.

For these reasons, consuming countries *as a whole* do not face an overall balance of payments or a reserve problem. What they do face is an immense current account deficit, financed in effect by a large and growing mortgage on their assets (and on their export capacities) by a highly concentrated group of foreign countries.

Plainly, this makes us feel uncomfortable. Part of our discomfort is related to fears over the extent to which our economies and financial markets may be exposed to influence or direction from abroad, or from overtly political manipulation of funds. Part of our discomfort also involves the question of whether the accumulating debts can ever be repaid.

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Both questions, and particularly the latter, turn in large part on the aggregate size of the claims accumulated by the OPEC countries. This is not an area in which we can expect forecasts to be precise or reliable as the time horizon is extended. In 1974, the OPEC countries apparently accumulated almost $60 billion of financial assets.[3] Next year, if prices do not drop, many current expectations are that the total could be almost as large. Thereafter, projections diverge more sharply, but a consensus is growing, growing out of new official and private estimates, that some early appraisals of the magnitudes involved were far too large.

For instance, some extrapolations (such as those of the World Bank in mid 1974) suggested a cumulative total of $600–$700 billion by 1980 and of $1¼ trillion by 1985.[4] These are truly staggering numbers. They seemed to justify a feeling that the huge financing operations would not be economically feasible or politically tolerable. In the short space of six years, OPEC countries would have acquired amounts equal to perhaps three-fourths of the current (depressed) value of all the stocks traded on the leading stock markets of the world, or perhaps a fifth of all existing financial assets—debt and equity—in the United States!

Today, with the benefit of greater experience, particularly of the ability and willingness of OPEC countries to expand their imports and of consuming countries to reduce demands for OPEC oil, most projections suggest the total accumulation, even at present oil prices and with allowance for compound interest, may run to no more than $300 billion by 1980, and then level off.[5] Some estimates suggest lower volumes, and a still earlier peak. Obviously, uncertainty still surrounds those projections, and debts of that magnitude would still raise difficult questions. But in the aggregate they probably could be managed by industrialized countries provided—and this is crucial—individual countries do not end up with a disproportionate share of the debt.

Financial Intermediation—Who Gets What, When

So far, consuming countries have been considered largely as a unit, and thus the practical problem faced by individual countries and by financial markets has been ignored. Consuming countries are not a unit, and within each country there are many borrowers. A debt burden tolerable for all industrial countries as a group will not be tolerable if loaded primarily on only a few of those countries. The money must flow through many markets and financial institutions before the supplies of credit from the producers can be matched with demands. Governments and private

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3. Ibid., p. 245.
4. World Bank, "Prospects of the Developing Countries," (Report 477, unpublished background paper, March 1974).
5. Chenery, "Restructuring the World Economy," op. cit., pp. 249–58; Morgan Guaranty, "Oil: Looking Back and Looking Ahead," op. cit., pp. 1–8; and Thomas D. Willet, "The Oil Transfer Problem" (Paper delivered to a panel on "The World Financial Structure: Coping with Inflation and International Payments Problems" at Quandrangular Conference II, Georgetown University Center for Strategic and International Studies, 29 January 1975).

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parties must be prepared, and equipped, to take large currency and credit risks if the process is not to break down.

So far, existing market facilities, broadly defined to include direct purchases of government or government-guaranteed securities at market terms by OPEC countries as well as transactions involving private intermediaries and financial instruments, have handled the bulk of the flows from the producers. Initially, the Euromarkets were the favored vehicle. Now somewhat more may be following into governmental paper.

Only a limited portion—probably less than a quarter—has been accounted for by arrangements specifically developed to deal with oil money, such as the oil facility of the IMF, rearrangement of the financing patterns of the World Bank, and special bilateral credits. But in this game, the first $60 billion is the easiest.

Private intermediaries operate on the law of large numbers. They normally want to spread both their assets and liabilities among a large number of debtors and creditors, so their liquidity or their solvency will not be drastically affected by the fortunes or actions of any one, or any small number, of their customers. They need to maintain a reasonable balance in the maturity of their assets and liabilities. They need to support growth by more or less proportionate increases in capital.

In all these respects, the recycling of oil money—on top of all the other demands growing out of the inflationary process—promises to present problems unless adequate alternative facilities are provided. There are only a relative handful of OPEC lenders and consuming country borrowers. For a variety of reasons—traditional, political, and economic—OPEC countries have wanted to deal with relatively few institutions and to emphasize extremely short credits. In contrast, both borrowing countries and businesses want the assurance of long-term money. The inflationary process has weakened relative capital positions, and new equity is expensive, when available at all.

The most pressing aspect of the problem is that some countries, even among industrial nations, may not be able to borrow the amounts they require to cover deficits in their current accounts. In a few instances where exceptionally large "oil deficits" have been superimposed on an already weak current account, lenders are already heavily committed, and shy away from new credits.

In concept, the "hidden hand" of the market would provide a solution to these problems. Offers of OPEC short-term money would attract a low interest rate or go begging. Consequently, those countries would be induced to lengthen maturities to diversify, and to accept higher risks. In the process, businesses and nations eager for longer-term money and capital could more readily satisfy their needs. Financial intermediaries would be able to increase their lending spreads, and raise enough capital to support expanded operations. The more heavily indebted countries stretching the limits of credit-worthiness would be forced to make needed internal or external adjustments and conserve on energy imports. As a result, their relative trade position would be strengthened, their borrowing

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needs reduced, and doubts about their ability to service their debts dissipated. Other countries—with strong current accounts and now highly attractive to investors—would have inducements to expand or to permit their currencies to appreciate, and would find themselves with stronger trade competition. In time, the strength of their current accounts would presumably be reduced, evening out the deficits of consuming countries.

In practice, the danger is that this process, left to itself in coping with flows of unprecedented size, might leave in its wake a trail of failing institutions, disturbed markets, and political crises. Prospects for national prosperity, economic integration, and political cooperation would then be deeply affected. This is why there has been so much emphasis on coordinated official action to backstop the markets. In approaching that task, the "market model" is not irrelevant, for it points broadly in the directions that the economic adjustments must move if they are to be successful and sustainable.

The provision of official credit, in the first instance, involves only a relatively simple government decision. The more difficult question is whether, as a result of such decisions, weak credit is piled on top of weak credit and the basic need for adjustment, for conservation, and for increasing energy supplies is evaded. If so, short-term stability will be only found at the expense of compounding the underlying real problems.

The IMF, as an existing worldwide institution encompassing producers and consuming countries alike, is well-adapted to handling an important part of the intermediation or recycling problem. On the one hand, it can provide the producers (or other surplus countries) an asset carrying a collective credit guarantee. It can meet desires for liquidity by making the asset transferable in the event of a balance of payments need, confident that if and when one holder of the asset has a deficit, another member country will have a surplus. The funds obtained from producers can be pooled and relent to countries in need for a relatively long period of time, again with some confidence that aggregate needs for money should match available supplies. Currency risks are shared between lender and borrower, and commercial interest rates can be paid and earned.

A limited "oil facility" was established along these lines in early 1974. Recent decisions expand and modify that facility for 1975. It was planned to accommodate a magnitude of $6 billion, and presumably it could be expanded further if necessary. Due to its limited size, however, U.S. negotiators resisted that approach, and proposed an alternative.

This alternative approach, set forth by Secretaries Kissinger and Simon, more explicitly tied the creation of new financial facilities to an attack on the non-financial aspects of the problem.[6] They pushed for a new institution to provide mutual credits and guarantees among the main OECD countries on a strictly stand-by basis.

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6. See U.S., Department of State, Bureau of Public Affairs, Office of Media Services, "Energy Crisis: Strategy for Cooperative Action" (Address by Secretary of State Henry A. Kissinger, Chicago, Illinois, 14 November 1974) and U.S., Department of the Treasury, Bureau of Public Information, Address by Secretary of the Treasury William Simon, New York, N.Y., 18 November 1974.

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OPEC countries could not be part of the arrangement, and would remain free to make their investment decisions in the market. As a result of their decisions, and the subsequent reallocation of funds through the market, the U.S.-sponsored approach recognized the possibility that some OECD countries would find themselves unable to meet pressing needs. At that point, the new institution might step in and agree to extend loans to that country by raising the funds by itself by borrowing from the government or central bank of a surplus-member country, or perhaps by guaranteeing a market borrowing in such country. The new credits would clearly be dependent on satisfactory assurances that the borrowing country would eschew restrictive trade measures, would adequately cooperate in the overall effort to conserve energy and to develop alternate supplies, and would undertake appropriate policies to avoid a disproportionately large current account deficit.

With a new arrangement of this sort, relative voting powers and financial obligations needed, of course, to be freshly negotiated. But this and other potentially contentious points appear to have been resolved, and an agreement in principle has been reached, subject to resolution of details and necessary legislative authority. Aggregate commitments to lend or limitations on borrowing by the member countries will total $25 billion; the volume of loans outstanding at any time could not exceed one-half of the $25 billion, because at that point both lenders and borrowers within the group would have reached the limit of their individual lines.

These initiatives are encouraging, for the potential need seems apparent. Both face up to the risks of total reliance on private markets—the IMF approach by channelling a portion of the surplus oil revenues directly through an official channel, the U.S. approach by providing a "backstop" or "safety net" for hard-pressed deficit countries. Both are compatible with expanded use of the ordinary resources of the IMF and with an expansion in those resources. Neither would exclude official bilateral or regional lending and borrowing operations.

While they differ in the emphasis placed on the need for the major consuming countries to cooperate in an agreed energy program and in the extent to which active cooperation by producing countries is required, they can easily exist side by side. The principal difficulty may be that, relative to possible needs, the amounts involved appear minimal. It is understandable that countries faced with large unknowns—and particularly countries visualizing themselves as potential lenders—are reluctant to provide a large "blank check" for the use of potential borrowers. Indeed, a "blank check" is not what the situation requires. As suggested earlier, there is a danger that individual countries can become over-extended. The distinction between "oil deficits" and an "old-fashioned" balance of payments deficit will inevitably be blurred over time, and individual countries, as in the past, will not be able to escape adjustment problems. External "disciplines" are a part of this process, and the provision of credit should not be a substitute for adjustment. U.S. thinking

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clearly goes beyond this traditional concern by attempting, in the new situation, posed by oil, to make use of new credit facilities contingent upon "consumer solidarity" in dealing with the energy problem.

All of this is legitimate and understandable, but we are left with a question of scale. Should the contemplated facilities prove inadequate, as they might, one hopes and expects that governments will be alert to expand them.

Neither recycling approach can effectively meet the problem of developing countries that have no reasonable prospect of affording the higher oil bills, much less accumulating interest charges. For better or worse, prospects for taxpayers in the United States or other consuming countries providing a large portion of the new requirements seems to be very poor. Indeed, in the United States we have been laggard in maintaining the momentum of existing aid programs and in funding the multilateral lending institutions—our first and urgent responsibility is to meet this requirement. Perhaps, profits generated by sales of gold by the IMF or by a differential in borrowing and lending charges by an official recycling facility, could generate some of the additional money needed. In any event, the moral and practical case for the producing countries assuming much of this new burden seems to me unassailable. Some steps have been made in that direction, but this effort needs much more attention.

There is another, and longer range, aspect of the process of financial intermediation between consuming and producing countries that will require continuing effort. Recycling facilities can help cover balance of payments deficits, but so long as countries are borrowing simply to maintain consumption, repayment of the debt (and payment of interest) will place a larger burden on future generations. If, on the other hand, the new foreign indebtedness is matched by increased productive investment, the future burdens will be ameliorated. Moreover, even apart from the oil problem, the case in the United States at least for higher levels of investment is very strong.

Larger investment will add to the already substantial needs of many businesses for equity and longer-term capital. Shortages of this kind of risk capital are an impediment to the investment we need. At the same time, we are all conscious of the vast new financial resources of the Arab countries, and their need to search out attractive investment opportunities.

Yet, the difficulties of matching up the apparent need with the apparent supply are well known. Both the potential providers and the potential users of capital lack experience in evaluating each others needs. Potential investors can only slowly build confidence in their own personnel and in foreign middlemen over time. Those needing funds must learn whom to approach and how. Traditional borrowing and lending patterns die hard.

These are the sort of problems, admittedly in exaggerated form, that provide the raison-d'etre—and attractive profit opportunities—for our banks and investment institutions. They are hard at work, but the job is greatly complicated by political concerns and suspicions—by the Western

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businessman or his government fearing that sizable Arab investment may mean loss of control and political manipulation, and by the Arab investor who fears that more permanent forms of investment may provide a hostage to political fortune.

One approach toward ameliorating this problem is taking the form of some limited joint ventures of Arab investors with Western financial institutions or businesses, with both sides placing some funds at risk and sharing in management. But the question arises whether, as part of a cooperative producer-consumer effort, that kind of model might not be substantially broadened, with advantages for both sides.

An increasing number of observers have picked up the germ of an idea set forth a year ago by the then Secretary of Treasury George Shultz, but never pushed by the U.S. government.[7] A number of variants of the idea have been expressed, but all have in common the notion of some official and multilateral sponsorship of an investment institution or fund (or funds) designed to pool a portion of the producers' surplus and investing those funds in a variety of longer-term profitable investments.[8]

One could, for instance, envisage one or more multilaterally managed "investment banks" or "mutual funds" being established under mutually agreed ground rules, with equity participation and management shared among a variety of private institutions, or governments, or both. Ownership and management would be more or less equally divided among producing and consuming countries. Although the bulk of the loanable funds would be raised from the producers, they would receive the bulk of the revenues and presumably wish to control certain basic management guidelines. The institution would presumably have very broad investment authority, including equity and direct investment, and would be guided by normal commercial criteria.

One basic object in providing such a multilateral umbrella over the investment process would be to offer protection and reassurance to lenders and borrowers alike about political risks. In the process, anonymity of investors would be lost; the investment process would necessarily become more open. In the long run, however, it is doubtful that large investment and anonymity are consistent.

Whether or not this particular approach becomes practicable, the danger of political fears and sensitivities thwarting the process of long-term investment is real. It is a matter that needs frank discussion at a producer-consumer conference, so that reasonable codes of conduct can be developed on both sides. It seems short-sighted indeed for the United States—long the champion of free international investment—to turn its back on potential investment from abroad at a time when that capital could be so usefully employed.

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7. U.S., Department of the Treasury, Bureau of Public Information, "The Need for Closer International Financial Cooperation" (Remarks by former Secretary of the Treasury George Shultz before the International Energy Conference, Washington, D.C., 14 February 1974).

8. See, for example, Khodadad Farmanfarmaian et. al., "How Can the World Afford OPEC Oil?," Foreign Affairs, 53, no. 2 (January 1975), pp. 201–22.

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Inflation and Recession

Thus far, the oil situation has been discussed almost as if it existed in a vacuum—as if we could determine more or less precisely the dimensions of the problem, develop a logical response, and go about our business in the context of otherwise stable and orderly markets. But in fact, these markets have been disturbed and weakened by persistent inflationary pressures, and now, with inflation still strong, industrialized countries find levels of unemployment moving to and beyond postwar peaks, injecting a further element of uncertainty.

Inflation long antedates the oil crisis, but there is no doubt that the abrupt jump in oil prices has sharpened the inflation-recession dilemma. The "cost-push" effects—spreading out through competitive fuels, secondary products such as fertilizer and other chemicals, and eventually into wage bargaining—gave inflation a strong new impetus. Less obvious, but noted by many economists, the higher bill for imported oil has diverted tens of billions of dollars of consumer purchasing power in industrialized countries into the savings of producers.

This siphoning off of purchasing power in higher oil prices unquestionably has contributed to the sluggishness of consumer spending in many countries, and helps account for the severity of recessionary tendencies. In that sense, it has complicated the immediate problems of demand management. It is an important reason why, in the short run, strong fiscal action through tax relief is appropriate to support purchasing power.

For the longer run, we can find opportunity out of adversity. Many thoughtful observers have long been concerned that the world may face a more or less chronic shortage of capital—an inability to generate the level of savings necessary to support the productive investment we need both for growth and now for enlargement of our sources of energy. It is indeed awkward that the new source of savings is lodged in a relative handful of countries, some of them of uncertain political and economic stability. But, for the time being, that is where the savings are, and absorbing those savings in government deficits is not their most constructive use. Instead, the challenge, as suggested above, is to match those new savings with higher levels of investment activity.

This is not the place to attempt a full analysis of our inflationary and recessionary problems and prospects. Suffice it to say that, in the United States at least, it is likely that price pressures will abate noticeably under the pressures of a recession that promises to exceed the most severe of the postwar period in depth and duration. In these circumstances, short-term interest rates have declined sharply and may continue to do so for a time. These downward pressures are being transmitted into long-term credit markets and encouraging some recovery of bond and stock prices. But the extent and rapidity of that recovery is questionable, partly because large amounts of new financing will be necessary simply to strengthen the balance sheets of businesses and financial institutions and partly because experience with inflation has made investors chary about undertaking long-term commitments.

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One element in a sensible overall strategy for dealing with our dilemma of inflation and recession seems clear enough. Pressures on industrial capacity, dependence on foreign oil, and productivity problems have all contributed to the severity of inflation. If we fail to deal with these problems as we seek renewed expansion, we simply risk a fresh outburst of inflation long before full recovery is achieved.

One cannot be oblivious to the practical difficulties—political and economic—of achieving what might be termed an investment-led recovery. A variety of measures will be needed to remove tax or other impediments, or to provide fresh incentives. But one critical factor is financing. That is why effective and efficient use of the savings of the oil producers in our capital markets seems so much in our interest, as well as in theirs.

Conclusion

We are passing through an economic crisis, a political crisis, and most of all a crisis of confidence. This is not one of those times when we can afford to sit back and bask in the glory of our traditions and history, confident that events will sort themselves out, that markets will adjust, and that we can soon go about our business in quieter times. Neither can we anticipate some new dramatic initiative by one government, or a group of governments, suddenly to sweep away the clouds from the sky. The problems are too complicated, power is too diffuse, perceived interests are too varied, domestic constituencies are too split and too restive to offer much prospect of that.

But a starting point for action is a conviction that our financial and economic problems are soluble. Indeed, many of the essential ingredients of an effective response are well known and some are in place or under negotiation:

1. *Perhaps most important, we need to avoid yielding to temptations to adopt negative, self-serving policies that would, in the end, destroy the necessary fabric of cooperation and be mutually destructive. Proliferation of import restrictions and export controls, beggar-my-neighbor currency policies, and excessive restrictions on foreign investment, all fall in that category.*
2. *Effective programs to conserve energy and increase supplies must be central and essential elements in any approach to the oil problem, and offer the best chance to bring about reduced prices. Here we must pass from the phase of oratory to action. President Ford's program—whatever one thinks of the specifics—puts this issue squarely on the table. It needs a period of debate—followed by action.*
3. *Official arrangements to facilitate and backstop the recycling of petrodollars are necessary, feasible and being put in place. We should be ready to expand those facilities as necessary.*

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4. *In moving to promote renewed economic expansion, we need to emphasize support and encouragement for business investment. Effective use of the savings of the oil producers offers new opportunities.*

This is not meant to be a complete program, but it provides a large and practicable start. The fact that we have large problems, without clear and certain solutions, is amply apparent. But to sit immobile, cowed by a doomsday perspective, is hardly appropriate. The simple fact is the problems are manageable if we are willing to make the effort to manage them.

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