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STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee

DATE: August 7, 1990

FROM: Normand Bernard N.B.

SUBJECT: Notes on oil price developments and their potential effects.

Attached are the notes that Mr. Truman prepared for his presentation to the Committee yesterday afternoon.

Attachment

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Class II - FOMC

E. M. Truman
August 6, 1990

Notes for FOMC Presentation

I. Introduction

A. The spot price of West Texas Intermediate (WTI) has risen approximately $11-1/2 per barrel since early July, from $16.50 per barrel to about $28 per barrel today.

B. About $4 of that increase can be accounted for by the "accord" reached among Persian Gulf producers in mid-July.

1. They agreed to reduce production about 1 million barrels per day (mbd) from production levels in July.

2. Their agreement was ratified by the rest of OPEC in late July.

C. The remainder of the increase in spot oil prices has occurred in the aftermath of the Iraqi invasion of Kuwait.

II. Analytical Questions and Answers

Q1 -- How much oil did Kuwait and Iraq produce in July?

Answer: About 4.9 mbd.

Q2 -- How much excess production capacity did OPEC have in July?

Answer: The industry's estimate is 4.9 mbd.

Q3 -- How much of that excess capacity was accounted for by Iraq and Kuwait?

Answer: About 1.1 mbd, implying that 3.8 mbd was outside of Iraq and Kuwait.

Q4 -- What is the estimated impact of a cut in OPEC oil production of 1 mbd that is sustained for a year?

Answer: The staff's rule of thumb is $4 per barrel.

Q5 -- What would be the impact on oil prices if all of Iraq and Kuwait's oil production were shut down and there were no increase in production elsewhere relative to production levels in July?

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Answer: The lost production would be 4.9 mbd, implying an increase in the price of oil of $20 per barrel to $36.50 per barrel from the price prevailing in early July.

Q6 -- What would be the impact on oil prices if all of Iraq and Kuwait's oil production were shut down and the rest of OPEC produced at full capacity?

Answer: The net loss in production would be 1 mbd, implying an increase in the price of oil of $4 per barrel, or approximately what we estimate would be consistent with the July accord. However, the distribution of production would be quite different than that envisaged under the accord.

Q7 -- What are the estimated impacts on the U.S. economy of higher oil prices?

Answer: Dusting off the historical relationships embedded in the staff's macroeconometric models, and <u>assuming that U.S. money growth would be unchanged</u>, the staff's rules of thumb for the impact of a $5 increase in the price of imported oil (roughly calibrated to current conditions) are (a) 1 percent on the CPI in the first year and an additional 1/4 percent in the second year and (b) 1/2 percent lower real GNP in the first year and an additional 1/4 percent in the second year.

III. Comments

1. The staff is still trying to sort out and interpret recent developments in what is clearly a very uncertain environment.

2. The short-run impacts are negative -- oil prices will be higher than in the Greenbook forecast prepared for the July FOMC meeting and higher than the $4 per barrel implied by the July accord. (The July accord level would be about $3 higher than in the last Greenbook forecast.)P

3. The medium-term impacts are likely to be more a function of politics than of economics.