

Why cheaper oil cannot buy a U.S. economic recovery

by David Goldman

Secretary of State George Shultz told the Senate Foreign Relations Committee on Feb. 15 that lower oil prices would bring about American economic recovery, and that this recovery would ward off an international monetary crisis brought about by the debt problems of the developing sector. Privately, the administration does not believe this. State Department officials report in "background discussions" that the recovery argument must be employed to dissuade advocates of debt moratoria among the Ibero-American nations, however dubious the argument's merits. At the Council of Economic Advisers, discussion has begun, tentatively, to focus on the "structural problems" of the American economy which inhibit recovery through conventional means. At the White House itself, the 1939-44 "model" of "self-financing budget deficits" is under discussion as a way forward.

The *EIR*'s LaRouche-Riemann econometric report demonstrates clearly that an oil price decline will have negligible effects on overall output of the United States. In some categories of industry, different price levels make a very big difference; but for the machine, construction, and chemicals sectors, the increase in demand for their products due to lower oil prices just about compensates them for the falling-off of demand due to lower oil industry capital investment.

Should the decline in oil prices produce even a 2 percent rise in interest rates—through OPEC disinvestment in American Treasury securities and a lower deposit flow to international banks—all the positive effects of even a \$20 per barrel oil price would be wiped out. And if the falling oil price destroys the paper-thin financial package that has kept Mexico away from default, the oil price decline might produce utterly disastrous effects.

A \$25 oil price under anticipated production levels would produce a \$66 billion OPEC current-account deficit, i.e., an additional \$66 billion in OPEC financial demand on world credit markets; this compares to a net investment in these markets of an average of \$100 billion during 1980-1981. Under the cited circumstances, Saudi Arabia would find itself in a \$26 billion current-account deficit.

It might be anticipated that the Saudis would swing from a net \$10 billion purchaser of Treasury securities to a net \$10 billion liquidator, adding an effective \$20 billion to the financing requirements of the Treasury. Since the nearly \$300

billion total net borrowing requirement of the U.S. government and its agencies during 1983 has already produced significant upward pressures on interest rates, the consequences of an additional \$20 billion financing requirement from non-OPEC sources relative to last year represents a considerable problem.

Given the generalized crisis of the world banking system, it is impossible to isolate the "OPEC factor" in world interest rates. Nonetheless, it is evident that a sharp decline in OPEC deposits and purchases of Treasury securities will have a decidedly upward impact on short-term interest rates.

Of more fundamental importance than the financial consequences of a reduction in oil prices, however, is the position of the American economy after a decade in which "energy conservation" or high-cost energy alternatives have dominated capital investment.

Five years ago, before the spectacular boom in oil drilling, a price fall from the then-prevailing \$14 per barrel price might have made a big difference. At this point, so much of American investment is bound up in production of expensive energy that a reduction in oil-related investments will cancel out almost all of the positive impact of an oil price reduction.

Since the highest-productivity sectors of the American economy, especially machinery, have depended on high oil prices for a substantial portion of their sales, a drop in the oil price—and a collapse of oil investments—hits the economy's strongest sources of growth. This is sufficient to wipe out the benefits derived from additional consumer income and corporate earnings through lower energy prices.

The final conclusion as such is indisputable: the study on which this article is based assembled (for the first time) complete data on the oil industry's use of rigs, drilling platforms, pipe, chemicals, pumps, trucks, and other capital goods, and examined the effect of different oil price levels on the oil industry's purchases of such goods (as well as export demand for such goods).

Then, the impact of both the rise in consumer and corporate demand was measured against the consequences of lower capital investment, using the LaRouche-Riemann model of the American economy. That economic model has produced the only consistently accurate forecast of the American economy during the past three years.

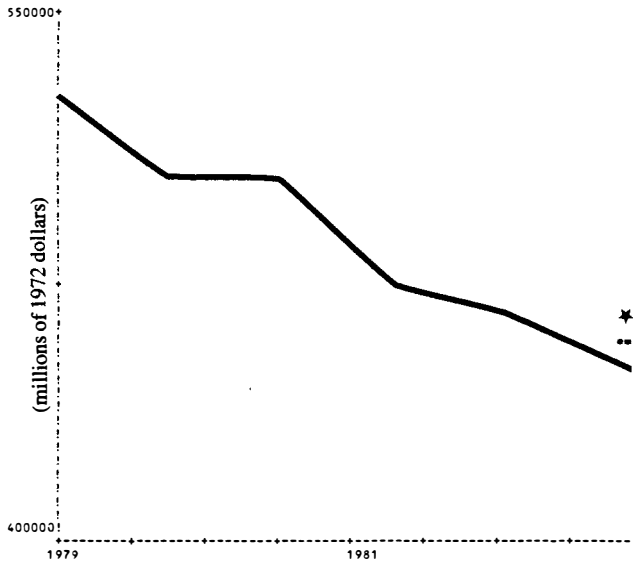
Cost of expensive energy

Presented in this form, the conclusion is inescapable that Shultz is either lying or thoroughly incompetent in economic policy matters. But another, more disturbing, question is raised: if the economy will not recover as a result of lower oil prices, under what circumstances can it recover?

The answer implicit in the study is "under no circumstan-

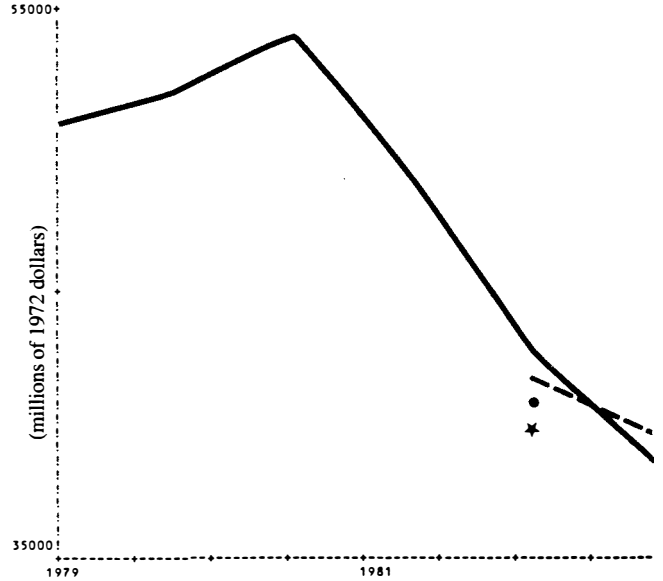
ces that exclude a technological revolution in American industry." For the past six years, from 1977 through the end of 1982, the U.S. oil industry has engaged in an exercise of exhausting economic supplies of oil; the more it invested in lower-yield wells, the less new output per unit of new investment, to the point that output did not rise even through the peak of new drilling from 1979 to 1981!

Figure 1



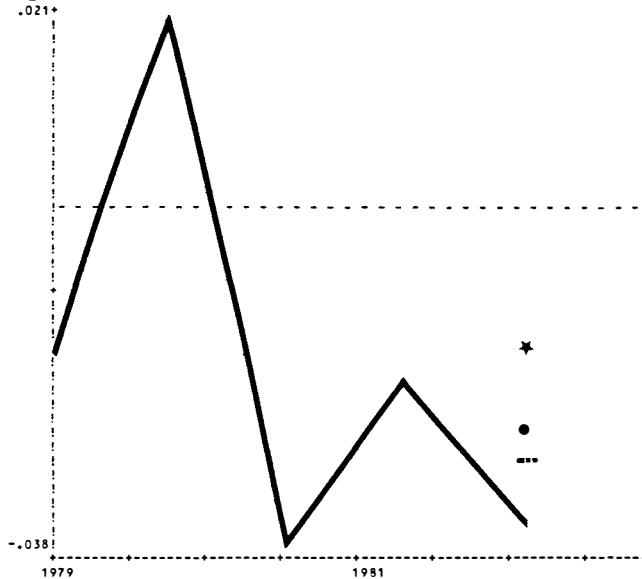
Total tangible profit:
 no oil price drop —, \$5 drop ---, \$9 drop ●, \$14 drop ★
 \$9 drop followed the same trajectory as the \$5 drop.

Figure 3



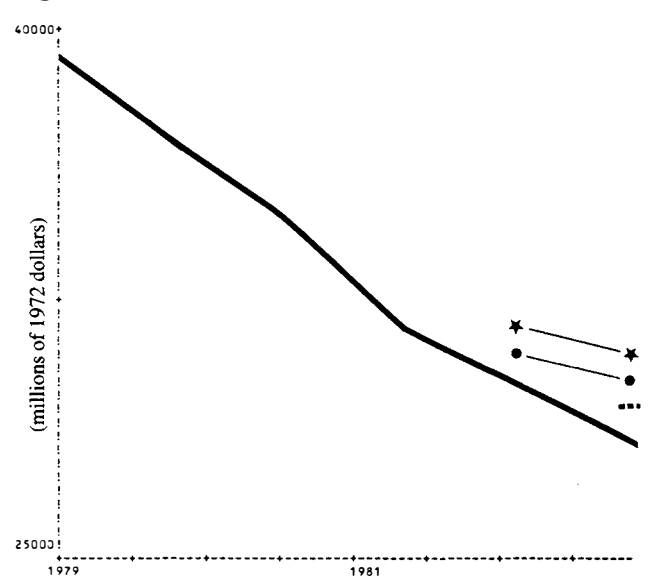
Machinery tangible profit:
 no oil price drop —, \$5 drop ---, \$9 drop ●, \$14 drop ★

Figure 2



Net reinvestment per unit of total operating cost:
 no oil price drop —, \$5 drop ---, \$9 drop ●, \$14 drop ★

Figure 4



Transportation tangible profit:
 no oil price drop —, \$5 drop ---, \$9 drop ●, \$14 drop ★

Oil drilling cost 10 times as much per well in 1982 as in 1961, partly because oilmen drilled deeper to find less accessible oil, partly because drilling conditions were less favorable in the new fields opened up. The staggering demands for pipe, rigs, chemicals, and other equipment could only be financed through huge doses of new credit, on the anticipation of higher oil prices. The drop in oil prices over the past year has already forced a reduction of drilling by nearly half, and more is to come. The decline in activity has been punctuated by a wave of bankruptcies that may ultimately hit hundreds of independent oil drilling and equipment firms.

An economy which invests huge portions of its capital into an industry whose output does not rise is in big trouble. One might say that oil is a special case, since the exhaustion of domestic reserves forces a rising cost-curve for new discoveries. But the steel and auto industries are not substantially different. American steel companies, which refused to build modern plants (like the Japanese) and patched up their old facilities, sank billions into "investment" and have less capacity now than five years ago. Auto makers sank billions into redesigning cars and reconstructing assembly lines to produce "fuel-efficient" cars, and now produce fewer cars than they did 10 years ago.

These are not "natural" events; but neither is the oil disaster. By concentrating on "energy conservation" and expensive domestic oil rather than building new sources of cheap power, nuclear generating stations, for example, the American economy spent the majority of its available investment capital during the past 10 years to produce as much, or less, of the things it needs! Had the same—or a quarter of the same—investments been made in nuclear energy, the United States would now be awash in cheap electricity.

Consider the structure of the American economy: about one-quarter of its potential workforce receives unemployment insurance, or early retirement benefits, or welfare, or other forms of federal support, which represent de facto a tax on the country's productive structure. Of the three-quarters employed, there are three service workers for every goods-producing worker; that is, fewer than one-fifth of all working-age Americans are now producing goods. Of these, most who are producing capital goods are consigned to "energy conservation" or exorbitantly expensive domestic oil production; their labor adds nothing to the economy's future capacity to grow.

In the base run used as the starting point against which different oil scenarios might be analyzed, the economy shows negative growth over 1983-84. The model treats the U. S. economy as a single agro-industrial firm, whose output is measured as the constant-1972 dollar volume of tangible goods production, and whose employment of service, government, and other non-goods-producing personnel (including the 23 percent unemployed) is counted as "overhead," just as a manufacturing firm must count as overhead its clerks, sales force, managers, and so forth. This breaks with conventional economic treatment, and rightly so, since the prac-

tice of including all incomes in Gross National Product double-counts the incomes of non-goods-producing workers.

Just as in the case of an individual firm, a nation that devotes more and more of its earnings to overhead expenses (plus interest costs and taxes) will first cut back capital expenditures, and ultimately reduce its payroll and inventories and production level. That is the case of the American economy now. The impact of the federal budget deficit on interest rates, the perennial subject of financial press commentaries, merely reflects what the LaRouche-Riemann model can measure in terms of the physical economy: the legal demands for payments to overhead account, including the distorted employment profile as well as the swollen unemployment and related expenses of the Treasury, exceed the production of tangible goods in excess of the replacement costs of goods-producing industry.

That is, the "fund" for overhead expenses is the tangible profit of goods-producing industry, i.e., production in excess of labor, capital-goods replacement, and raw materials costs. If the demand for overhead is in excess of tangible profit, the difference must be made up through a reduction in the current production inputs, i.e., a decline of output.

This situation is immediately the result of Paul Volcker's credit rampage of the past three years, but also the result of the Carter administration's insane energy policies, as well as the Ford administration's incompetent response to the rise of oil prices in 1973-74.

The result is an economy which is beyond susceptibility to the normal means of bringing about economic recovery. Removing the pressure of oil prices does not work. This is not to say that the economy cannot recover under any circumstances. Were the thin margin of available capital investment to be applied to industries in which technological breakthroughs were occurring, the productivity effects of such investments would transform the economy within a few years, repairing the damage of more than a decade.

That is the promise of President Reagan's beam-weapons program; the massive, Manhattan Project-style investment in this field promises to create a technology-driver for the civilian economy, and the only way out of the present mess. These technologies were examined in detail in *EIR's* Special Report, "Beam Weapons: The Science to Prevent Nuclear War." A preliminary assessment of their economic impact was published in *EIR's* January Quarterly Economic Report for the U.S. economy. A more detailed assessment of the recovery prospects of the American economy through a defense-based "R&D-driver" is in progress and scheduled for May release.

This article was adapted from a brief excerpt of EIR's new multi-client special report, titled "Oil Price 1983: Problems and Prospects." It includes the full LaRouche-Riemann computer analysis of the oil-price drop's effect on the U.S. economy; a political analysis of London's manipulations of the OPEC pricing structure; and an extensive report on the prospects for U.S. oil and oil-equipment producers. Available for \$250 from EIR's Special Services Department.