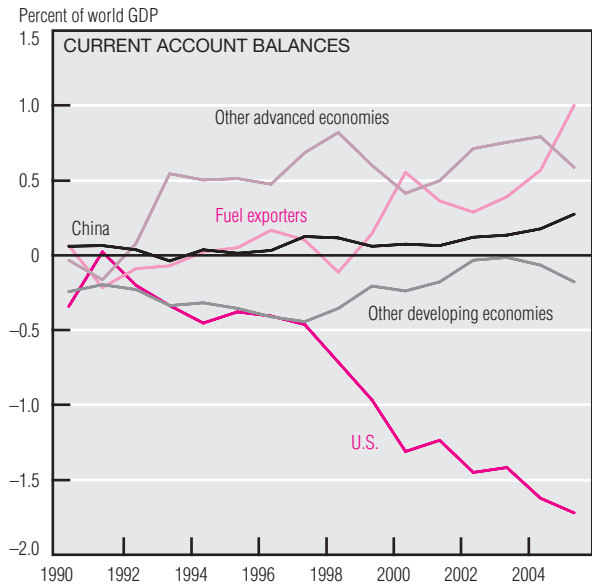
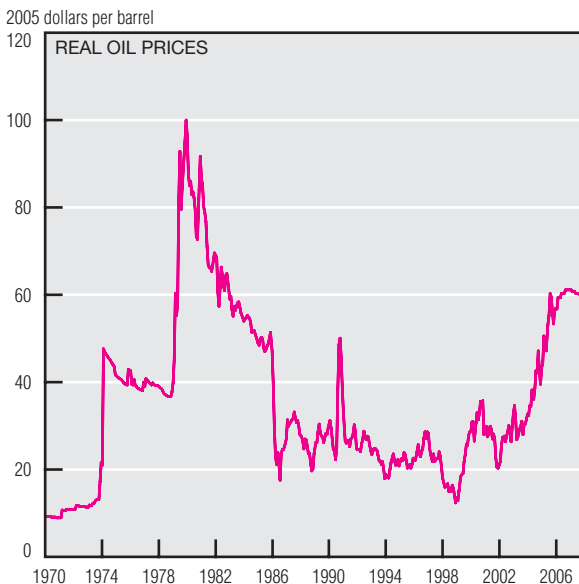
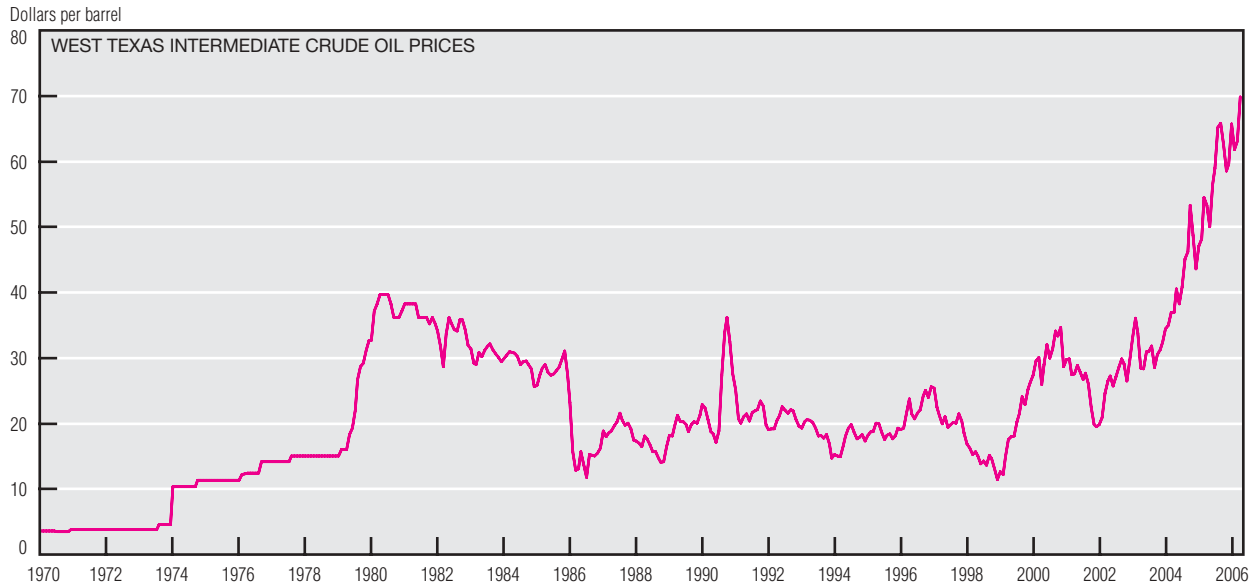


Petrodollars



SOURCES: International Monetary Fund, "Globalization and Inflation," *World Economic Outlook*, April 2006, pp. 71–96; the *Wall Street Journal*, the *Economist*, April 22, 2006, p. 74; and Haver Analytics.

The price of oil has risen fairly steadily, from \$20 per barrel in 2002 to \$60–\$70 this year. Although oil prices are setting new records, the real price of a barrel of oil—the price after stripping out the effects of inflation—remains well below the record reached in late 1979. This inflation adjustment, together with greater energy efficiency, helps to explain why the recent round of energy-price hikes has not hit oil importers as severely as in the late 1970s and early 1980s.

Nevertheless, higher oil prices and a rising, price-insensitive demand for crude have recently increased the real export revenues of oil-producing countries more sharply than at any time in the past, according to International Monetary Fund (IMF) estimates. Real export revenues reached \$763 billion last year, more than double the revenues just three years earlier. How the oil-exporting countries recycle their petrodollars—oil is priced and traded in U.S. dollars—can

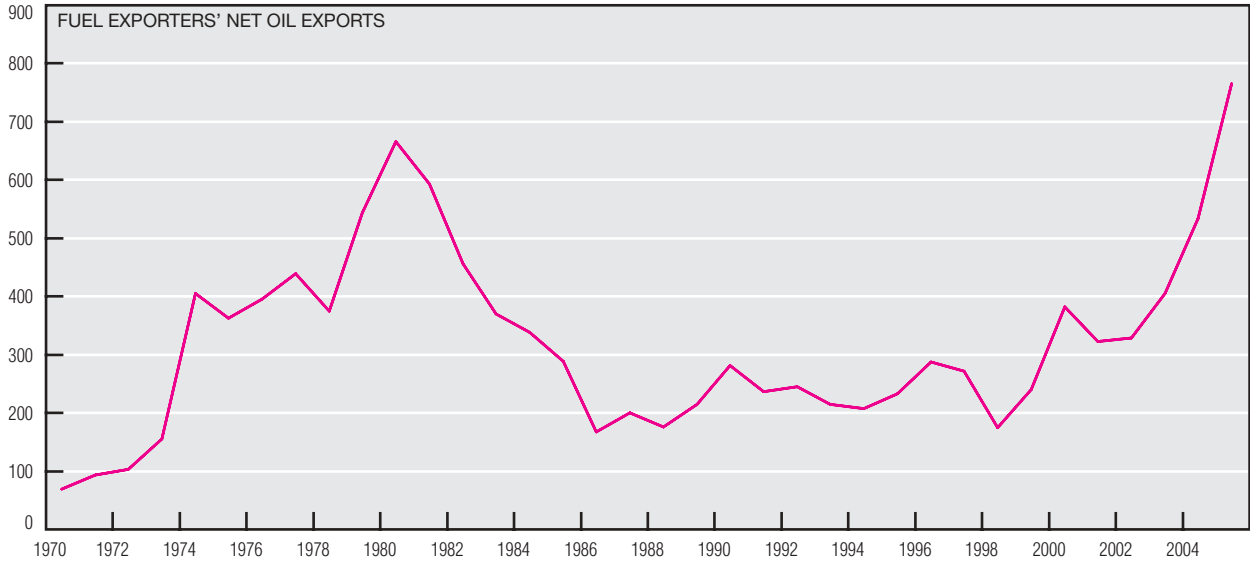
have important implications for how the world adjusts to oil-price shocks.

Oil-exporting countries are spending a smaller share of their export revenues on imports than before, even though a much larger portion of the current oil-price run-up may prove to be permanent. For example, the IMF estimates that OPEC is currently spending 24% of each additional oil dollar, compared with 42% between 1978 and 1981, and 52% between 1973 and 1975. Moreover,

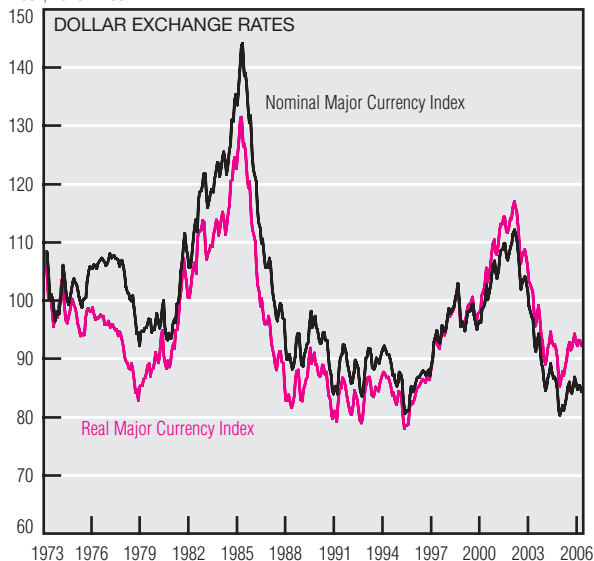
(continued on next page)

Petrodollars (cont.)

Billions of 2005 U.S. dollars



Index, 1973 = 100



Percent



SOURCES: Board of Governors of the Federal Reserve System, "Foreign Exchange Rates," *Federal Reserve Statistical Releases*, H.10; International Monetary Fund, "Globalization and Inflation," *World Economic Outlook*, April 2006, pp. 71–96; the *Economist*, April 22, 2006, p. 74; and Haver Analytics.

oil producers are currently buying a smaller share of their overall foreign imports from the U.S. than in 1981. In 2004, oil exporters obtained approximately 8.4% of their merchandise imports from the U.S., which is not such a bad thing from the oil exporters' perspective. Usefully spending this large amount in a short time is difficult, but it also implies that oil-importing countries—particularly the U.S.—will experience larger current account deficits than in the past. The IMF estimates that over the past two years, higher oil prices have

accounted for approximately half of the deterioration in the U.S. current account position.

Instead of spending their revenues, oil producers are saving them. Petrodollars have moved directly and indirectly into the U.S. securities markets. (During the 1970s and early 1980s, oil exporters re-channeled a larger proportion of their unspent revenues in the form of bank loans.) The inflow of oil revenues has helped to finance our growing current account deficit without significantly higher interest rates in the United

States or a sharp depreciation of the dollar. The IMF estimates that the flow of petrodollars into the U.S. bond market could recently have shaved—at most—one-third of a percentage point off of 10-year Treasury bond yields.

While inflows of petrodollars may ease the financing of our current account deficits, they cannot maintain a fundamentally unsustainable situation indefinitely. Petrodollars merely delay and prolong the adjustment process.