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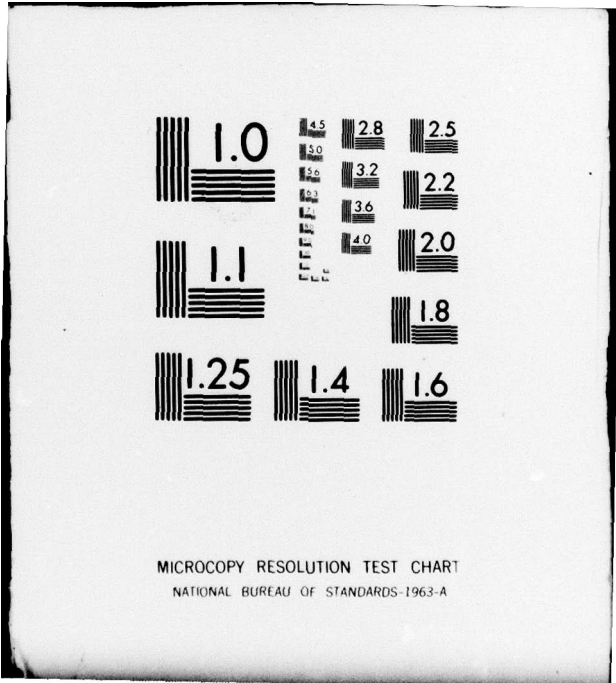
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EXTERNAL RESEARCH STUDY

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A Summary of an Oral Presentation by  
Richard N. Cooper, Yale University

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FOREWORD

During a discussion session, on October 25, 1974, on the international payments problem caused by high oil prices, Professor Richard N. Cooper of Yale University presented a thoughtful analysis and an action proposal, both of which are summarized in the following pages. Cooper believes that the period of greatest global danger will occur in the very near future--possibly within four or five months.

As part of a Department of State analysis of the international payments problem, the Department's Bureau of Intelligence and Research, Office of Economic Research and Analysis (INR/REC), asked Professor Cooper, an INR consultant, to make this presentation, in view of his stature in the field of international economics and the fact that the oil/payments problem underlies most of the world's current political-economic issues. The summary of Professor Cooper's analysis and proposal which follows was prepared in INR/REC by A. Mascaro and J. St. John.

INR's consultant program is managed by the Office of External Research. Consultant studies are designed to supplement the Department's in-house research capabilities by providing independent, expert views on key questions.

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PETRODOLLARS AND WORLD PAYMENTS

Part I: Cooper's Analysis of the Oil/Payments Situation

Characterizing the fourfold increase in petroleum prices in less than a year as the most severe shock to the world economy since World War II, Cooper estimated the magnitude of the consumer countries' combined current account deficit (i.e., OPEC surplus earnings) at about \$45 billion in 1974, accumulating to about \$200 billion by 1980. He said the salient feature of these deficits is that they will be self-financing: i.e., oil exporters must at least bank these funds, thus making them potentially available for lending. Most will inevitably go into liquid dollar assets, with the New York and Eurodollar markets getting the bulk of the deposits since they are the only markets able to absorb such amounts.

Normally, financial arbitrage between the world's financial centers would tend to spread lendable funds throughout the banking system, ultimately pairing the needs of borrowers with the funds made available by primary depositors.<sup>1/</sup> However, since the bulk of petrodollar deposits are concentrated in the accounts of relatively few oil exporters, prudent banking practices and regulations governing bank behavior will act to throttle the

<sup>1/</sup> Cooper felt the Eurodollar market has fulfilled this role of financial intermediation reasonably well within the first half of 1974.

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- 2 -

flow of these funds and prevent their complete dispersal to all but a few select countries.

From the perspective of individual banks, the possibility of massive withdrawals of petrodollar deposits on short notice places rigid constraints upon their ability prudently to accept such funds on short term and lend them on medium or long term. In addition, rules and conventions in many countries restrict the proportion of total bank deposit liabilities permitted to stem from a single depositor. On the lending side, there are also regulatory rules or conventions on the acceptable ratio of loans to equity capital. Expansion of bank capital via equity issues is particularly difficult at the present time.

Noting that the largest Eurobanks have already begun to resist new petrodollar deposits (mainly by reducing the interest rate offered), Cooper foresees that, in the absence of intervention by governments or central banks, this form of recycling will all but cease within the next 5 months or so. He believes this will be accompanied in many deficit countries by imposition of import restraints because--despite the fact that achievement of overall balance by this method is collectively impossible--individual countries will feel compelled to take protective action in the absence of suitable alternatives.

Such a scenario would, should it eventuate, have a devastating effect upon world trade, employment, and living standards.

#### Part II: Cooper's Proposals

A. The Short Term. Inasmuch as Cooper believes that the period of greatest danger will occur during the next several months, he feels the US should quickly convoke a consortium of major central banks (principally the Federal Reserve, the Bundesbank, and the Bank of England), which would agree to:

--rediscount, on a large scale, loans made by individual commercial banks to governments in the event that large deposits of petrodollars are withdrawn from those banks:

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- 3 -

- relax any regulations or conventions governing the acceptable ratio of loans to bank capital, in order to facilitate relending of the large amounts now being generated;
- undertake close surveillance of the short- and medium-term money markets, especially on the lending side, in order to be fully apprised of the exposure of commercial banks with respect to their largest customers; and
- to publicize the above commitments widely.

Cooper believes that only the private banking system, with the help of central banks, can handle the short-term recycling problem; creation of new institutions, as envisioned in the second phase of his proposal, would take too long. He sees the backstopping of 20 to 30 of the world's largest commercial banks for a 1 1/2 year period in the manner described above as a logical and necessary exercise of the central banking function. He feels strongly that the present extraordinary circumstances require that ordinary banking conventions be stretched. Unless loans are made which would, under normal circumstances, be considered unbankable, Cooper believes there will be no way to avoid a threat of economic collapse and a retreat into national postures of sauve qui peut.

Cooper feels that central bank rediscounting operations might never actually have to take place--the mere presence of the central bank commitment might be enough to ward off large-scale withdrawals. If rediscounting should take place, the effect would be inflationary--an increase in the credit base--but this would only be temporary, could be offset in part by central bank action, and would be a small price for preserving the whole fabric of international finance. Cooper acknowledges that under this plan the ultimate burden of responsibility will fall on the Fed. But he argues that other central banks can and should share the burden short of a condition in extremis, and that there is simply no other way to avoid a condition which could lead to disaster.

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- 4 -

B. The Longer Term. Cooper advocates creation of a new international institution which, over the next 5 to 10 years, would receive OPEC funds at competitive rates and varying maturities, and lend to oil-consuming countries at non-concessional rates and for varying maturities.

The attractiveness of such an institution to OPEC is that it would spread the risk attendant to each investment among all the participating countries. In addition, it might overcome the reluctance of OPEC countries to deposit funds for long periods in those national money markets whose governments have a past history of "blocking" foreign deposits and other assets under certain circumstances. To the oil-consuming countries, of course, the benefit would lie in keeping the money effectively employed and reducing the motivation for the oil exporters to cut production.

This plan avoids any need to revise the IMF Articles of Agreement as a means of attracting more OPEC funds, and at the same time it involves OPEC more directly in the international recycling mechanism. Furthermore, some of the risk would remain with OPEC members in case of default by a borrower. It would involve granting considerable decision-making power to OPEC, but Cooper sees no way to avoid this in any case.

C. Helping the Most Seriously Affected Developing Countries (MSAs). The above proposals do nothing for countries which lack the credit-worthiness to borrow on commercial terms.

Cooper feels the sums needed for these countries (he cites India and Bangladesh as examples) are not large relative to the amount of petrodollars available--probably less than \$2 billion in 1974. He recommends a two-pronged approach involving:

--direct aid from the oil exporters, either through a two-tier price system or by direct loans on concessional terms, and

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- 5 -

--financial intermediation by the IMF or IBRD, in which the latter borrows on the world market at commercial rates and re-lends to the MSAs at a highly concessional rate. This rate could be subsidized by market sales of IMF gold stocks. (Cooper estimates that selling only 1/25 of the fund's holdings would yield a capital gain of \$300-350 million, while reducing the market price of gold to about \$80-100 per ounce.)

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