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Are the Oil-Payments Deficits Manageable?

The quintupling of oil prices within a period of two years has confronted oil-importing nations with a multitude of difficult political and economic problems. Paramount among these is the question whether the international payments system will be able to weather the strains involved in massive financial transfers to nations whose low absorptive capacities, in many cases, prevent them from increasing expenditures abroad in step with the explosive increase of their income. In 1974, the first full year of sharply higher oil prices, the nations of the Organization of Petroleum Exporting Countries (OPEC) enjoyed a current-account surplus with the rest of the world estimated at $55 billion. In 1975, notwithstanding a serious recession in the industrial world, the OPEC surplus is generally expected to be almost as great. Is it realistic to expect that the oil-importing countries will be able to finance the extraordinary deficits that correspond to OPEC's surpluses? The unprecedented magnitude of the problem and the uncertainty of the outcome led one participant at the September 1974 annual meeting of the International Monetary Fund to say, according to the *New York Times*, "On Mondays, Wednesdays, and Fridays, I think we're all going to fall into some kind of chaos that I cannot exactly describe. On Tuesdays, Thursdays, and Saturdays, I think we'll get through it all right. On Sundays, I stop thinking and rest."

Financing Prospects

An assessment of the prospects for financing can start with the observation that, whatever the oil deficits are, they *will* be financed, right down to the last cent. What is more, directly or indirectly, the requisite financing will be provided entirely by the OPEC countries themselves.

Unfortunately, these observations do not resolve the problem. To say that all deficits will be financed is only to say that the balance-of-payments suit will be cut to fit the financing cloth. There can never be a deficit that is not financed. So the question is really whether, after all the forces bearing on oil have worked themselves through, the resulting deficits reflect levels of oil supply, economic activity, and real income that the various countries can live with.

Perhaps, before proceeding, it would be well to explain how we can be so sure that OPEC will exactly finance whatever oil deficits emerge. The reason is that the OPEC nations, being unable to spend all their

sharply increased foreign-exchange earnings, must necessarily accumulate assets which, by their very nature, have to remain within the money and capital markets or the industrial structure of the oil-importing countries. For example, if the OPEC countries were completely passive, their foreign investments would take the form of the currencies or demand deposits received for their oil. Since every dollar of OPEC surplus corresponds to a dollar of an importing country's deficit, and since every dollar of surplus is invested abroad somewhere, it follows that the total amount of financial recycling by OPEC nations will exactly suffice to close the collective oil-payments gap of the importing countries. The trouble with this seemingly comforting line of reasoning is, again, that OPEC investments will cover the importing countries' deficits as fully when the deficits are large (and the associated oil flows ample) as when the deficits are small (and the oil flows so inadequate that industrial production falters). Thus, recycling will always suffice to cover the collective current-account oil deficits of the importing countries, but we cannot be certain whether it will do so in a manner consistent with acceptable levels of real income in the various importing countries.

The problem of oil financing, or "petrodollars," or "recycling," as it is variously termed, has numerous roots: sharply higher prices for oil; the price inelasticity of the demand for oil, particularly in the short run; the limited absorptive capacity of a number of key oil-producing countries; and meager prospects, at least in the near term, for substantially increased energy production outside the present OPEC membership. These circumstances result in greatly increased revenues to the oil exporters, but considerably smaller increases in their imports from the rest of the world, so that the OPEC countries amass vast financial surpluses. The oil-exporting countries recognize that this process creates hardships for some of their customers, and they are prepared to join the industrial nations in providing some financial assistance. Beyond that, however, they have assumed no responsibility for the financial needs of the oil-importing countries. They give evidence of being prudent and conservative investors and have so far favored liquid assets in strong financial institutions and strong countries.

Adam Smith is remembered, among other reasons, for divining that competition, like an "invisible hand," transmutes the selfish actions of individuals into the common good. Such an "invisible hand," however, cannot be counted on in all situations. OPEC itself, for example, is not exactly the kind of competitive set-up that Adam Smith had in mind. And Keynes's *General Theory* demonstrated that individual thrift, gen-

erally regarded as a virtue, could lead to high unemployment and economic stagnation when practiced by everyone.

All this has applicability to OPEC's investment predilections. Although their investment decisions make a great deal of sense from the viewpoint of an individual engaged in prudent financial management, their decisions in aggregate could have harmful consequences. They could preclude a satisfactory recycling process, with adverse repercussions for income, output, and employment in the entire community of nations and for long-term growth prospects of the developing countries.

How might this happen? A key aspect of the recycling problem is the question of who bears the credit risks involved. The OPEC countries—not unreasonably—have exhibited a clear preference for low-risk investments. Roughly two-thirds of the $55 billion OPEC surplus in 1974 was invested in liquid assets—one-half in bank deposits and one-sixth in government securities. Only about 5 per cent was made available as direct grants and loans to developing countries (see Table 1).

TABLE 1

ESTIMATED DISPOSITION OF OPEC SURPLUSES IN 1974
(in billions of dollars)

Bank deposits		$27.5
Dollars in United States	$ 4.5	
Sterling in United Kingdom	2.5	
Eurocurrencies	20.5	
Marketable government securities		9.5
United States	6.0	
United Kingdom	3.5	
Direct investments in developed countries		0.8
Portfolio and real estate investments in developed countries		1.0
Direct loans to official institutions in developed countries		6.5
Loans to international financial institutions		4.2
International Monetary Fund	2.0	
World Bank and other development banks	2.2	
Direct grants and loans to developing countries		2.5
Other		3.0
Military-assistance grants to Arab nations	1.8	
Debt repayment	0.7	
Participation payments to oil companies	0.5	
Total		$55.0

SOURCE: Morgan Guaranty Trust Company.

In effect, the OPEC countries have placed their funds in currencies and financial institutions of their choice and left it to those institutions and other intermediaries to assume most of the credit risks associated with recycling these funds to needy oil-importing countries. The general nature of this process is indicated in Table 2, which lists the estimated current-account deficits of major industrial countries in 1974 and government actions to finance them.

TABLE 2

ESTIMATED CURRENT-ACCOUNT POSITIONS IN 1974 AND GOVERNMENT FINANCING ACTIONS
(in billions of dollars)

	Current Account		*Capital Account*		
				Known Government Borrowing Commitments	
	Overall Balance	*Increase (–) in Net Oil Expenditures from 1973 (c.i.f.)*	*OPEC Deposits, Loans, and Investments*	*In Private Money Markets*	*From IMF, EEC, Other Governments*
U.S.	–$4.0	–$17.8[a]	$11.0	$ 0	$ 0
Germany	8.6	– 6.7	0.5	0	– 2.0[b]
U.K.	– 9.2	– 6.5	6.0	4.2	0
France	– 6.1	– 6.9	1.2	2.8	0
Italy	– 9.0	– 5.4	1.2	2.0	6.2
Japan	– 4.6	– 14.4	1.0	8.6[c]	0

[a] f.o.b.

[b] Bundesbank loan to Italy, included in Italy's $6.2 billion borrowings.

[c] Includes $8.5 billion of interbank borrowing which the Japanese government encouraged the commercial banks to undertake.

SOURCES: National Statistics, U.S. Commerce Department, Morgan Guaranty Trust Co.

Germany was in the strongest position, retaining a current-account surplus of nearly $9 billion despite a $6.7 billion increase in oil-import expenditures. Far from seeking to borrow money abroad, the German government, via the Bundesbank, provided Italy with a $2 billion credit. The United States was in a strong position too. Although it had the largest increase in oil payments, strength in other trade and service items reduced the current-account deficit to $4 billion, and this deficit was considerably less than some $11 billion of capital inflows from OPEC.

The other major oil-importing nations were in less comfortable posi-

tions. The United Kingdom was able to cover its higher oil-import bill with capital inflows from OPEC, but the need to finance a large current-account deficit led the government to arrange substantial credits in the Eurocurrency market, some of which were not called upon until the early part of 1975. France, Italy, and Japan received far less capital from OPEC than was needed to finance their increased oil-import bills. Moreover, while France and Japan were able to obtain needed Eurocurrency and interbank loans, Italy's attempts to borrow in the private capital markets were only partially successful. In the face of widespread concern regarding its creditworthiness, the Italian government was obliged to resort to more than $6 billion of borrowing from official lenders—the International Monetary Fund, the German government, and the Common Market.

Apart from this official lending to Italy, most of the intermediation has been done by the large banks of the Eurocurrency market, the United States, and Germany. Publicly announced Eurocurrency bank credits rose by $28.0 billion in 1974, while U.S. and German banks increased their foreign loans by $18.3 and $8.3 billion, respectively.

As 1974 progressed, however, these private institutions were unable to maintain their early pace of intermediation. They were increasingly limited not only by considerations of borrower creditworthiness but also by other constraints of sound management. OPEC contributed to these additional constraints. The conservatism that manifested itself in risk aversion was also manifest in a strong preference for short-term, and therefore highly liquid, investments. This preference runs counter to the oil-financing needs of the importing countries, which are generally medium- to long-term. Unfortunately for the recycling process, there are limits on the degree to which a bank can build medium- and long-term loans on a foundation of short-term deposits. And, as 1974 unfolded, those limits were apparently reached in a growing number of cases.

As a result of the various constraints, the pace of new Eurocurrency bank-credit announcements slowed sharply in the second half of 1974: 71 per cent of the year's $28.0 billion total fell in the first half, 16 per cent in the third quarter, and only 13 per cent in the fourth quarter. In the case of U.S. banks, actual loan utilizations, as distinguished from credit announcements, followed the same general pattern, except that the fourth quarter was stronger than the third. On a seasonally adjusted basis, 69 per cent of the $18.3 billion total occurred in the first half, 10 per cent in the third quarter, and 20 per cent in the final quarter.

As 1974 drew to a close, some mitigation of emerging strains appeared likely as a result of adaptation in the private markets and in OPEC investment patterns. For example, new issues on the international bond market rose toward the end of the year, offsetting some of the concurrent slowdown in bank lending. And it seemed likely that bond issues would be further encouraged by declining interest rates and waning inflationary pressures associated with the current world recession. At the same time, OPEC governments began to place funds directly with borrowers, with bankers acting as brokers in bringing lenders and borrowers together. This is a constructive way of harnessing banking expertise without subjecting the banks to risks and strains that could slow the flow of capital. Dr. Otmar Emminger, Deputy Governor of the Bundesbank, was recently reported to have said that several billions of OPEC dollars have been placed through the brokerage services of major European and American banks since June 1974.

Although these developments were promising, they did not go far enough to assuage mounting concern about the sustainability of the oil-distorted structure of international payments. It was clear that OPEC's liquidity preference and risk aversion were so strong that, even with some flexibility on OPEC's part, much intermediation would still be necessary to recycle funds more or less in relation to the needs of individual countries. And there was growing apprehension that intermediation through the private money and capital markets would be unable to keep pace with requirements because of limits set by the credit risks involved, the need to maintain a reasonable balance between the maturities of deposits and loans, inadequate bank capitalization, and other constraints on prudent management.

It was in this setting of mounting concern that a major breakthrough occurred. Through most of 1974, the U.S. government had emphasized the overriding importance of achieving lower oil prices. American officials had steadfastly opposed proposals for new official financing arrangements, evidently because they felt (correctly) that anything that facilitated financing would tend to keep oil prices from falling. In the middle of November, however, Secretary Kissinger announced a major change in policy. In a speech in Chicago, he proposed that the OECD nations create a "solidarity" fund to serve as a financial "safety net" in coping with the balance-of-payments strains of expensive oil. He suggested that the fund be fixed at $25 billion for 1975, with additional amounts to be subscribed later in the light of future needs.

Political considerations were important, if not overriding, in the U.S. decision to change course. Earlier, the United States had scored a no-

table success in its efforts to rebuild the Western alliance after the divisive effects of OPEC embargoes and production cutbacks. It offered to share oil supplies in periods of emergency and to set up a cooperative system for this purpose within the Organization for Economic Cooperation and Development (OECD). This was an important step toward security of supply. But most oil-importing countries remained vulnerable financially. The Kissinger proposal for a solidarity fund was designed to mitigate this vulnerability and, in particular, to do so without any reliance on financial contributions from OPEC. Since OPEC's financial surpluses would, in any event, have to be invested abroad and, as a practical matter, mainly in the OECD countries, there was no doubt about the availability of funds for the OECD countries as a group. And the United States evidently wanted OECD nations to look "within the family" for financial help, even though the credit risks would also have to be borne by the OECD governments; to shift the credit risk to OPEC could have made the weaker OECD nations beholden to OPEC for financial assistance. Thus, the Kissinger plan provided the second main foundation stone—emergency supply sharing was the first—in a grand strategy for building up mutual security in the face of OPEC pressures.

The other OECD nations, perhaps more concerned about credit risk and less averse to reliance on OPEC financing, professed little enthusiasm for the Kissinger plan. They preferred, instead, a substantial enlargement of the IMF's special oil facility, to be financed largely by borrowings directly from OPEC countries. In the end, the inevitable compromise promised a surprisingly large pool of funds. The Kissinger plan was approved, subject to parliamentary ratification, with an initial capitalization of SDR 20 billion (roughly $25 billion), and an SDR 5 billion (about $6 billion) expansion of the IMF's special oil facility was authorized for 1975. It was subsequently agreed that contributions to the solidarity fund, or Financial Support Fund, as it was formally titled, could be in cash or in the form of guaranties for joint loans on behalf of the fund.

These decisions will not furnish $31 billion of financing capability in 1975. Legislative action on the Financial Support Fund may not be favorable in all cases; the outcome in the U.S. Congress is particularly uncertain. Further, even if ultimate ratification were not in doubt, inevitable delays in the process of achieving it will virtually preclude the fund from beginning its operations this year. Finally, the $25 billion fund will be made up of contributions or guaranties by potential debtors as well as by creditors, and will therefore provide far less than $25 billion of usable funds. Possibly only half the $25 billion—the quotas of

the United States, Germany, Switzerland, Austria, the Netherlands, Belgium, and perhaps a few others—may actually be available for lending. Still, it would be no mean achievement to create financing capabilities totaling around $20 billion in the face of a problem that will assuredly be large, even in 1976 and beyond.

Do these recent developments suggest that the problems of financing oil deficits are being resolved, at least for the industrial countries? There is no way to be sure. The new multilateral arrangements, once put in place, will buy time. Acute financing problems will be pushed into the future, perhaps by several years. But whether the new arrangements will suffice depends on the size of future oil-related payments deficits. On this question, widely diverging expert opinions have been expressed during the past year, reflecting not only different perceptions of the problem at any given moment, but also a general tendency toward lower estimates with the passage of time. The economists of Morgan Guaranty Trust Company were among the optimists, projecting that OPEC's collective annual surplus would turn into a deficit in 1979, after the cumulative total peaked at $248 billion in current dollars in 1978. Dr. Otmar Emminger of the Bundesbank has suggested that OPEC's current-account surplus may be eliminated by 1980, and David Rockefeller, Chairman of the Chase Manhattan Bank, is reported to agree but to believe that the cumulative surplus will peak in the range of $300-$350 billion. The OECD's latest projections suggest that there will be little, if any, accumulation after 1980, when the accumulation will have reached $200-$250 billion in 1974 dollars. This would correspond to a range of some $325-$400 billion in current dollars.

The U.S. Treasury Department, in a paper by Deputy Assistant Secretary Thomas D. Willett delivered in January 1975, estimated that total OPEC accumulations by 1980 would reach $200-$300 billion in 1974 dollars, and this would represent a wide range of approximately $300-$500 billion in current dollars. The Treasury did not foresee a sharp decumulation after 1980. It did say that "accumulations would be unlikely to prove substantially higher in 1985 than in 1980, and there is a good chance that the 1985 figures would even fall below the 1980 level." Subsequently, Treasury estimates were revised downward. On May 5, 1975, Assistant Secretary Charles A. Cooper testified: "Current projections are that the accumulated investable surplus of the oil exporters as a group will have peaked by the end of this decade, if not before, in the range of $170-$250 billion (at 1974 prices)." This would be roughly $275-$400 billion in current prices. The World Bank is less optimistic. Its figures still point to an immense problem, although they have been revised down from earlier projections of a cumulative sur-

plus reaching $653 billion by 1980 and $1,206 billion by 1985 (both in current dollars). In an article in the January 1975 issue of *Foreign Affairs*, Hollis B. Chenery, Vice President for Development Policy of the Bank, said that OPEC's cumulative surplus might reach $300 billion in 1974 dollars by 1980, and this would be equivalent to about $500 billion in current dollars. He also suggested that OPEC's accumulation would continue into the 1980s. Subsequently, a World Bank study circulating confidentially among governments in April 1975 reportedly estimated that the cumulative OPEC surplus would reach $460 billion in current dollars by the end of 1980 and continue from there into new high territory. And Arthur F. Burns, Chairman of the U.S. Federal Reserve Board, has reportedly suggested that OPEC's cumulative surplus might be as large as $500 billion by 1980.

If the course of OPEC surpluses follows the path projected by forecasts at the low end of the range, the financing problem may prove to be manageable by private intermediation, direct lending by OPEC countries, bilateral loans among the OECD nations, and official facilities of the type already in place or expected to be established in the near future. Widespread awareness of the limitations of the private system may be causing excessive pessimism regarding its ability to play an important, continuing role. The potential for private intermediation in the future may have been somewhat depleted by last year's transactions, but it is far from exhausted. Lending constraints are being eased by the decline of short-term interest rates relative to medium- and long-term rates. This provides a stimulus for OPEC depositors to shift into deposits with longer maturity and for borrowers to seek loans with shorter maturity, thereby bringing into better balance the term structures of bank liabilities and assets. And the promise of a backstop of additional official credit may induce private lenders to step up their activities even before the expansion of multilateral facilities has actually been carried out.

If the accumulation of OPEC surpluses turns out to be at the high end of the range of the projections, however, financing may not be manageable without great difficulty, if at all. To be sure, there is likely to be more "give" in the system than first appearances might suggest. For example, while creditworthiness cannot be ignored by governments, official lending is not as narrowly constrained by considerations of creditworthiness as is private lending. And there are powerful influences tending to increase the willingness of governments to lend—influences that do not apply to private lenders. These are the unpleasant political and economic consequences of refusing to lend. We are all familiar with the argument that soft loans to poor countries are not only humanitarian

but serve the national security by helping to maintain political stability and keeping communism at bay. To these considerations must now be added a potent economic argument. In the absence of official lending, market forces could push up the exchange rates of the strong oil-importing countries—those which receive OPEC funds in excess of their own financing requirements and do not lend the excess funds to countries with shortfalls. The change in exchange rates would cause the strong countries to make room in their trade balances for goods that weak countries must sell, whether the strong countries like it or not. Thus the strong countries would have to endure temporarily, at least, the pains of lower output and higher unemployment because of the problems of the weak. There are advantages to a high or rising exchange rate, but the labor unions and the Hartkes and Burkes are more likely to see the drawbacks. The appreciation of strong countries' currencies could intensify pressures for import barriers, and these would simply make a bad situation worse. Under these circumstances, the governments of strong countries might be willing to close one eye to the credit risks involved in lending and opt for lending as the best of a sorry lot of alternatives.

The OPEC countries might also be prepared to expand their direct lending when compelled to confront the economic pressures generated by acute balance-of-payments disequilibria. Some of their loans would have the character of export credits, tending to support the demand for oil and thereby helping to maintain both price and volume of production.

Thus, the more serious the balance-of-payments strains of expensive oil, the greater will be the pressures for more official recycling by OPEC countries and by oil importers favored by capital inflows. But to speak of pressures for recycling is a far cry from saying that the pressures will suffice to call forth the requisite amount of financing. If OPEC's cumulative surplus mounts to the upper end of the range of the projections cited, sufficient financing may not be forthcoming to enable the importing nations to live more or less comfortably with expensive oil.

The Adjustment Process

To the extent that financing falls short, the world's oil trade will have to shrink back to a level that the importing countries can afford. This will result from the operation of the adjustment process. Price and income effects are the primary free-market ingredients of the process, and these may be supplemented by externally oriented governmental measures such as devaluation, import restrictions, exchange controls, and export promotion. In addition, selective internal measures directly aimed