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THE WITTEVEEN FACILITY AND THE OPEC FINANCIAL SURPLUSES

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HEARINGS

BEFORE THE

SUBCOMMITTEE ON

FOREIGN ECONOMIC POLICY

OF THE

COMMITTEE ON FOREIGN RELATIONS

UNITED STATES SENATE

NINETY-FIFTH CONGRESS

FIRST SESSION

SEPTEMBER 21, 23, OCTOBER 6, 7, AND 10, 1977

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THE WITTEVEEN FACILITY AND THE OPEC FINANCIAL SURPLUSES

WEDNESDAY, SEPTEMBER 21, 1977

UNITED STATES SENATE,
SUBCOMMITTEE ON FOREIGN ECONOMIC POLICY
OF THE COMMITTEE ON FOREIGN RELATIONS,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:40 a.m., in room 4221, Dirksen Senate Office Building, Hon. Frank Church (chairman of the subcommittee) presiding.

Present: Senators Church, Clark, Sarbanes, and Javits.

Also present: Mr. Norvill Jones, chief of staff; and Jerome Levinson, chief counsel.

OPENING STATEMENT BY SENATOR CHURCH

Senator CHURCH. The hearing will please come to order.

This is the first of 5 days of scheduled hearings by the subcommittee with respect to the administration's proposal for authorization for the United States to participate in the supplementary financing facility of the International Monetary Fund, the so-called Witteveen Facility.

The total amount of additional resources to be provided by the IMF amounts to approximately \$10 billion. The administration proposes that the United States contribute \$1.7 billion to this facility.

But what is at issue in these hearings is not merely the authorization for an additional U.S. contribution to a worthy multilateral lending organization. What is at issue is whether the developed countries have a coherent strategy for dealing with what I consider to be potentially the most serious international economic crisis since the 1930's: the burgeoning spiral of oil prices and mounting international deficits—debt of a magnitude we could not even imagine 5 years ago.

The Witteveen facility, as I understand it, is designed to disburse over 3 years. The fundamental question that I think we have to ask is will this program contribute to bringing the international economy into a stable equilibrium 3 years from now, or will we then find ourselves even further engulfed in the debt trap?

Under the best of circumstances, so long as the OPEC cartel continues to mandate the oil price, we can look forward to continuing surplus funds accumulating in the accounts of a few oil-producing governments at the rate of \$40 billion a year, necessitating international deficit financing of perhaps \$70 billion per year.

This assumes stability of oil prices in real terms, plus adjustment policies on the part of deficit countries amounting to stringent eco-

nomic austerity, and a steady noninflationary real growth in the industrialized world—assumptions that I think we have little reason to believe, on the basis of experience, will hold.

Yet, if we are to believe the administration's own forecasts, the present surplus of crude oil—the oil glut—is a temporary phenomenon which will give way to severe shortages in the early 1980's, just at the time the Witteveen Facility has run out. At the same time, it is proposed we sell Iran AWAC's costing an additional \$1.2 billion, added on to the already colossal military sales program mounted there since the oil price rise of 1973. Thus, while the oil glut may help to mitigate further oil price rises in real terms over the next 3 years, Iran, which was the major price hawk in 1973, will be chafing at the bit by the early 1980's to make up for the relative pause in oil revenues during the oil glut years.

Thus, the Witteveen Facility, and the associated private lending, will get us to the point where, under the best of circumstances, the international financial system will be staggering under \$220 billion of additional indebtedness, where, according to an American Express study, oil-deficit-developing countries will be using 50 cents out of every new dollar borrowed to amortize old debt; and, where the OPEC cartel remains in place, in as strong a position to increase prices as in 1973.

Where is the coherence in this policy?

The situation reminds me on an international scale of the plight of New York City. Everyone was on notice that debt was mounting beyond the capacity of the city to sustain it. But no one, neither the political nor the financial leadership of the city, could get off the treadmill. They just went on piling debts upon debts, hoping that some how, some way, something would come along to bail them out.

I am frank to say that I fear that we are on the same treadmill at the international financial level, but with much more perilous consequences, not only for the world economy, but for political democracy itself. The fundamental question we have to ask ourselves is whether we want to go on with a policy of a patch here and a patch there without any clear conception of how we are to break the Gordian knot of OPEC, deficits, and debt, debt, and more debt.

Our hearing this morning will primarily address the issue of the OPEC surpluses, their magnitudes, effect upon the financial markets, and the adequacy of the OPEC surplus states' contribution to the Witteveen Facility with respect to the problem it seeks to address.

We will start our hearing this morning with the first witness, Mr. Eugene Sherman, who is vice president of Merrill, Lynch Government Securities.

But before calling upon Mr. Sherman I will first defer to Senator Javits.

Senator JAVITS. Thank you, Mr. Chairman.

STATEMENT OF SENATOR JAVITS

Mr. Chairman, normally I would not make any statement at all. But I am appalled at the seeming lack of interest at what is to me likely to be the principal crisis of our time.

I have just returned from a meeting of the North Atlantic Assembly over the weekend. In fact, I got back only last night.

When I was there, in discussing the matter with our colleagues on the various committees, I stated that I was not nearly as much afraid of war as I was afraid of economic collapse. There was not only complete silence, which always indicates a very important point with parliamentary colleagues, but there was an enormous amount of approbation that this was the issue. They see it, but we apparently don't.

Now this is ghastly, and it is getting very much worse.

I appreciate the Chair's very informed and sophisticated analysis of the issue. It is worsened by the fact that the United States is literally becoming the obligated middleman, to wit, that we are receiving a great share of these surpluses of the OPEC countries. We are, in turn, becoming liable for them to the OPEC countries, and we are doing a recycling on our own credit, as it were.

As it is already, we have had testimony in our committee and have had reported testimony before the Committee on Banking and Urban Affairs by the lenders, that is, the banks, which have indicated that they are approaching the barrier, that they are pretty well loaned up.

The Witteveen Facility, considering the size of the indebtedness that is involved, is pitifully small. However, I shall be most receptive to it and I hope our committee, the Foreign Relations Committee, can recommend it favorably. But we started out with a minimum of \$15 billion and we are now down to \$10 billion. We started out with a safety net of \$25 billion for the developed countries and we are now down to nothing.

The banks are pretty well loaned up. The surplus, as we project it forward, now looks like at least \$40 billion a year for 7 years, which is a neat little item of about \$300 billion. That is what we have to look forward to.

Yet, the world seems like a whole bunch of lemmings heedlessly about the business of economic suicide, a far more imminent and present danger than suicide in war.

So, Mr. Chairman, I think these hearings are critical and I am deeply grateful to the Chair for calling them and for proposing to do so thorough a job. I should hope myself to participate.

There is one last thing. Mr. Chairman, I think our committee must do this. I think it can be subsumed under the heading of a Foreign Relations Committee most appropriately. There is the Finance Committee, the Ways and Means Committee, the Banking and Urban Affairs Committee, and others, each having a piece of the action when our policy should be, on the legislative side, just as coordinated as it is in the National Security Council at the White House. I believe this is a critical matter for our committee, Mr. Chairman, of which you are the ranking majority member after our Chairman Sparkman. I hope very much that we will address ourselves to that, too.

Thank you, Mr. Chairman.

Senator CHURCH. Thank you, Senator.

I think it is obvious that we have both said that we share a similar apprehension.

Mr. Sherman, do you have a prepared statement, or are you ready to respond to the committee's questions?

STATEMENT OF EUGENE J. SHERMAN, VICE PRESIDENT, MERRILL
LYNCH GOVERNMENT SECURITIES INC., NEW YORK, N.Y.

Mr. SHERMAN. I am ready to respond to your questions.
I would like to say that I thank you for the opportunity to represent our firm. We always stand ready to cooperate with the Congress.

MR. SHERMAN'S BACKGROUND

Senator CHURCH. How long have you been with Merrill Lynch?

Mr. SHERMAN. I have been with Merrill Lynch for $5\frac{1}{2}$ years, $3\frac{3}{4}$ years with the government securities dealer function, known as Merrill Lynch Government Securities Inc.

Senator CHURCH. What is your position?

What are your responsibilities?

Mr. SHERMAN. I am vice president and director of research, which includes analyzing and forecasting developments in the Government securities market. That ranges over a very wide number of areas, including monetary policy, fiscal policy, and the general area of forecasting interest rates, which means economic analysis.

Senator CHURCH. Among your responsibilities, is the preparation of the Merrill Lynch publications, "Weekly Government Securities" included?

Mr. SHERMAN. Yes.

WHAT IS MEANT BY OVERALLOTMENTS

Senator CHURCH. The May 20 issue of that publication states:

The Treasury—referring to our own Treasury—has been drawing on non-market sources for increasing amounts of funds. Among these are overallocments of notes to foreign governments and sales of bonds to State and local governments.

Would you explain what type of notes are involved and what is meant by overallocments?

Mr. SHERMAN. All right.

The obvious purpose of this hearing is to explore the international influence, so I will go through the State and local just very briefly.

The Treasury has arranged to issue special securities to State and local governments as they prerefund maturing issues. This has been going on for some time. But because of interest rate levels and market developments, it has become more economically feasible for the State and local governments to do this and so the numbers have become more meaningful from the point of view of the impact on the Government securities market.

To the extent the Treasury is able to issue such securities and raise money outside the secondary market, it reduces the burden of new issues on the secondary market.

Now, one of my roles, of course, is to anticipate the amount of financing the Treasury will need and comment on that as it might affect interest rates.

Now, more importantly from your point of view are what I have called the overallocments to foreign central banks. This procedure is as follows.

The Treasury will announce a new note or bond offering. Typically that would be a \$2 billion or \$3 billion issue. That issue is sold in auction. The market determines the price through the auction mechanism. There is a high price, a low price, and most importantly, an average price.

The Treasury then adds on to the amount sold some number, some amount of securities which foreign central banks have requested. So, if there is a \$2 billion note auction, we may find out in the subsequent published report of the Treasury's issue that they have added on to the \$2 billion \$500 million more for sale to foreign central banks and monetary authorities at the average of the auction in terms of yield or price.

Senator CHURCH. In this same issue there is a table—it is published on page 1—and there are two columns. Do you have them before you?

Mr. SHERMAN. Yes.

Senator CHURCH. One is called Overallotments of Marketable to International Monetary Authorities; the other is called Changes in Securities Held by Federal Reserve for Foreign Accounts.

Mr. SHERMAN. Yes.

Senator CHURCH. Would you refer to those two columns and analyze them for us?

Mr. SHERMAN. Yes.

What these two columns show is very simply this. In the first one, "Overallotments of Marketable to International Monetary Authorities," is that foreign central banks have been accumulating, or the Treasury has been selling to them, increasing amounts of issues which are marketable each quarter. So, the amounts were relatively nominal in Treasury securities in market terms through the second quarter of 1976. Then in the third quarter it started to build up. Thereafter it became quite substantial.

ADDITIONAL TABLES PROVIDED

I have provided for the record additional tables which bring through the third quarter the amount of such overallotments or add-ons that the Treasury has undertaken. The additional table, or supplemental table, which has been added to the record makes this a more complete picture.

I can tell you that the amounts continue to grow. According to our analysis, in the third quarter, not counting the 2-year note to be auctioned today, the Treasury will have supplied some \$2.5 billion of additional notes just in the third quarter to foreign-central banks and monetary authorities, and an additional \$237 million of 1-year Treasury bills—just in the third quarter—or a total of about \$2.8 billion.

So the figures continue to rise. The Treasury is selling amounts of securities to foreign central banks in excess of those sold in the public market of substantial amounts, and it is thereby reducing the amount of money the Treasury has to raise in the domestic market.

Senator CHURCH. What about the other column?

CHANGES IN SECURITIES HELD BY FOREIGN RESERVE

Mr. SHERMAN. The other column is "Changes in Securities Held by the Federal Reserve for Foreign Accounts." The Federal Reserve

stands ready, as an accommodation to foreign central banks, to buy and sell securities for their account. The Federal Reserve does this by coming into the public market, the secondary market, and announcing that it is buying a certain amount, or selling a certain amount, for the account of the customer.

Foreign central banks accumulate dollars and sometimes they reduce their holdings of dollars. Typically they keep their dollars invested in U.S. Treasury securities. As these dollar amounts vary, they would either sell the Treasury securities to raise the dollars, or they would invest their new-found dollars in Treasury securities.

An example of this was in the early part of the year when the United Kingdom was accumulating very large amounts of dollars and it invested those dollars in Treasury securities and the amounts were quite substantial.

In the first quarter of 1977, you can see that the figure was \$4 billion. We don't know for sure, but we presume that it was largely United Kingdom purchases because they were accumulating large amounts of dollars as they tried to keep the pound from rising. So, as they sold pounds they bought dollars in the foreign exchange markets, and they invested those dollars in Treasury securities.

That is completely apart from the amount of securities that the Treasury is selling directly to the central banks.

Senator CHURCH. I see.

If I read this chart correctly, it shows a marked increase in the overallotments, as shown in the first column, beginning with the last quarter of 1976 and continuing through 1977, is that correct?

Mr. SHERMAN. Yes.

QUANTITIES NOT OUTSTANDING

Senator CHURCH. What quantities are not outstanding at the foreign central banks?

Mr. SHERMAN. The figures are shown with somewhat of a lag, and it takes a bit of knowledge of the available statistics to put these things together.

The latest published figures are in the August Bulletin of the United States Treasury, and they report figures as of June 30. On June 30, there were outstanding \$41.3 billion of Treasury bills in the hands of foreign central banks.

Senator CHURCH. How much—\$41 billion?

Mr. SHERMAN. \$41.3 billion of Treasury bills; there was another \$17.8 billion of notes and bonds; this is a total of marketable securities of \$59.1 billion.

Then there was an additional \$20.9 billion of nonmarketable securities held by foreign central banks.

So, if you are looking at marketable securities, they held, on June 30, \$59.1 billion.

\$63 BILLION HELD AS MARKETABLE SECURITIES

Senator CHURCH. That is nearly \$60 billion worth of marketable securities—

Mr. SHERMAN. Yes; there is more.

Senator CHURCH [continuing]. Held by foreign central banks.

Mr. SHERMAN. With a little bit of more detective work, I can tell you that the figure is probably \$63 billion now.

The Federal Reserve reports weekly on Thursday nights on a report called, "Member Bank Reserves, Reserve Bank Credit, and Related Items," in a footnote item, the amount of marketable U.S. Government securities held in custody at the Federal Reserve Bank for foreign and international accounts. As of September 14, these figures were \$62.287 billion.

Now we know that there are some securities held by foreign central banks that are not held in custody at the Federal Reserve. I estimate that that runs around \$700 million now.

Senator CHURCH. So then, your best estimate is that presently there are \$63 billion worth of marketable securities, Treasury notes and bills, held by foreign central banks?

Mr. SHERMAN. That is correct.

Senator CHURCH. Plus \$20-odd billion more in nonmarketable securities?

Mr. SHERMAN. That is correct.

Senator CHURCH. What would those nonmarketable securities be?

TREASURY ARRANGEMENTS

Mr. SHERMAN. The Treasury has made financing arrangements with various central banks to buy Treasury securities at an interest rate, and the terms vary. Some are repayable within short notice—48 hours' notice. As a practical matter they don't do that. Some have longer maturities. Some are in foreign currencies, so that the Treasury has obligated itself to pay back in a particular currency. I believe the only foreign currency issues outstanding presently are in Swiss francs.

Senator CHURCH. The nonmarketable securities really represent a bilateral loan arrangement, isn't that so?

Mr. SHERMAN. Well, you might refer to it in that way. It is a borrowing by the Treasury.

Senator CHURCH. A borrowing by the Treasury. It is not marketable.

Mr. SHERMAN. Yes. The important difference is that the central bank must come to the Treasury if it chooses to liquidate. It may not sell it in the secondary market.

Senator CHURCH. Yes.

Then, between the two, we have something over \$80 billion outstanding, right?

Mr. SHERMAN. That's correct.

WHO IS PURCHASING U.S. GOVERNMENT SECURITIES?

Senator CHURCH. Do you have any indication of who is purchasing all of these U.S. Government securities?

Mr. SHERMAN. Well, we don't know for sure, but one can conjecture.

Senator CHURCH. Why don't we know?

Why shouldn't that be public information?

Mr. SHERMAN. There are long lags in the published information, so long that for our purposes it is not terribly useful.

The foreign central banks, in fact, any customer in the financial area prefers confidentiality in its dealings. It is a matter of long central

bank and finance ministry tradition to maintain confidentiality in financial dealings.

The best we can do to determine who are the investors is to figure out who are the reserve-accumulating countries.

I mentioned earlier that I did not know for sure, but that I presume that a good deal of the securities held by the Federal Reserve for a foreign account was United Kingdom securities.

I can conjecture that some of these securities, which I have referred to as overallocments, the add-ons to the regular note offerings, are countries that have reserve surpluses, or are accumulating surpluses. Such would include Japan, Germany, Saudi Arabia, the United Arab Emirates, and probably also Kuwait. But I could not specify that these are definitely the ones accumulating these additional notes.

BANKING AND PORTFOLIO SECURITY PLACEMENTS IN UNITED STATES

Senator CHURCH. Let's refer to chart 1 over here [indicating]. The caption is "Percentage Breakdown of Mideast Oil Exporters' Banking and Portfolio Security Placements in the United States, by Type."

I wonder if you would analyze that chart for us and explain just what it denotes.¹

Mr. SHERMAN. Well, the most obvious thing—and it is in red so I suppose it is intended to draw my attention to that line first—shows Treasury bills, notes, and bonds have been rising rather sharply, particularly in 1977; but it is clear that the trend began in the middle part of 1976, or the second half.

I guess that is the thrust of it. The Middle East oil exporters have taken on increasing proportions of Treasury securities. That would tend to confirm my conjecture that the reserve-accumulating countries, specifically Saudi Arabia, the United Arab Emirates, and Kuwait, have been the buyers.

Mr. LEVINSON. Actually, the chart parallels your own analysis.

Mr. SHERMAN. Yes; it does.

Mr. LEVINSON. In other words, starting in the last quarter of 1976, what we can see is a relatively sharp upward turn on into 1977, and your projection for the rest of 1977 indicates a considerable increase in the holdings, particularly compared to 1975 and 1974.

So, what we have is really a parallelism, which would tend to confirm your original analysis of what has been happening in the securities markets, and that would indicate where the money is going.

Mr. SHERMAN. Yes; I would concur with that.

Senator CHURCH. The chart suggests to me that the investments are being made by the surplus countries, the OPEC governments, in the United States and are increasingly being made in Treasury bills, notes, and bonds.

Mr. SHERMAN. Yes.

LIQUIDITY OF TREASURY NOTES AND BONDS

Senator CHURCH. That type of investment has a high degree of liquidity, does it not?

Mr. SHERMAN. Yes.

Senator CHURCH. That is, let's say, as compared to stocks in American corporations, or corporate bonds, or other types of investments.

¹ See appendix for charts, p. 184.

Mr. SHERMAN. Yes; absolutely. We take great pride in the Treasury securities market as to making secondary markets and providing liquidity for marketable securities.

Senator CHURCH. This is the kind of investment that can be quickly unloaded, so to speak?

Mr. SHERMAN. Yes.

OVERALLOTMENT PURCHASES

Senator CHURCH. With respect to the growth in overallocation purchases of Treasury notes, bills, and bonds, are these transacted in the same way that the average U.S. investor would make his purchases?

Mr. SHERMAN. The term, "average U.S. investor" should be defined.

If you are talking about the typical individual who might want to buy secondary market issues, the Treasury allows what we call non-competitive tenders for these notes and bonds of up to \$1 million. So, if any individual in the United States, or outside the United States for that matter, wants to buy it and be assured of getting the security at the average yield or average price, he may do so up to \$1 million, and in the case of 1-year Treasury bills, \$500,000.

If you are referring to "average U.S. investor" as an institutional investor—a large bank, pension fund, insurance company, corporation and so on—then no. Then that average investor, that large institutional investor, must enter a competitive auction and indicate on a tender the price or yield he is willing to pay for that security. It being an auction and competitive, he may pay too much, he may pay too little, or he may not get his securities at all.

THE FOREIGN CENTRAL BANKS

Senator CHURCH. What about the foreign central banks? Do they compete in the same way for their share of a fixed quantity of bonds being offered?

Mr. SHERMAN. No; and I am not aware that there is a fixed quantity.

The foreign central banks, as I understand it—well, there are two categories.

First, if a foreign central bank has an issue that is maturing, against which the Treasury is selling a new issue, they may automatically roll over their maturing security at the average price. If a foreign central bank wants to raise additional cash, either through instructions to the Federal Reserve or directly with the Treasury, it may arrange to do so at the average price, within reason, regardless of the amount it is seeking.

So, this has led to the so-called add-ons, or overallocations, wherein if the Treasury is selling a \$2 billion or \$2.5 billion issue, we find out after the auction that in addition to the \$2.5 billion sold to the public market, another \$500 million or \$600 million was sold at the average price to foreign central banks.

That does set them apart from the institutional investor in the United States.

THE AVERAGE PRICE

Senator CHURCH. That average price becomes the set price for the add-ons, right?

Mr. SHERMAN. Yes.

Senator CHURCH. Is this a new procedure?

When did you first notice this procedure?

Mr. SHERMAN. Well, we knew about it throughout 1976. We started to monitor it closely when the figures became significant.

But I was not particularly aware of this prior to 1976. We were always aware of the roll-over procedure at the Federal Reserve, but the figures had never been significant enough to give us a great deal of concern. Well, perhaps "concern," is not a good word, so I will say "direct our attention."

THE ADVANTAGE TO FOREIGN CENTRAL BANKS

Senator CHURCH. What is the advantage of foreign central banks placing their surplus in Treasury notes in the United States? Why are they doing it? Why this upward trend?

Mr. SHERMAN. Well, from their point of view, this is a very good investment.

First of all, you have the U.S. economy, which is large, growing, and successful in almost any respect you might analyze an economy. You have the United States, which is a politically stable environment and which has survived a great deal of distress over a couple of years and, I think, has emerged stronger. You have a banking system that is sound, which is backed up by the Federal Reserve, a lender of last resort. You have a socially stable environment. The work ethic still prevails in this country. So you have an economy in which you have a great deal of justification for making an investment. That means they are willing to hold U.S. dollars.

The safest U.S. dollar investment is Treasury securities, be they bills, notes, or bonds.

So, from a point of view of an accumulator of internationally mobile money, the dollar is a good selection. Then, once an investor has his dollars and wants to have a safe investment with the possibility or prospect of having it liquid, should he need it, I could not think of a better investment than U.S. Treasury securities.

OIL PRODUCERS' TOTALS

Mr. LEVINSON. Mr. Chairman, may I direct your attention to the chart over here [indicating], if Janice would just point to it. The column says, "Total U.S. Banking and Security Placements by Oil Exporting Countries," the first column. The figure in parenthesis, \$12.7 billion, of the \$26.6 billion there, is the amount of total U.S. Treasury bills, bonds, and notes outstanding which is held by Mideast oil producers as of June 30, 1977.

Senator CHURCH. What is the \$26.6 billion figure? Is that the total of Mideast oil producers?

Mr. LEVINSON. That is the full total.

Senator CHURCH. I see. That includes the commercial banks and the \$12.7 is Treasury notes and bonds.

That has been going up progressively, hasn't it?

Mr. LEVINSON. Yes.

In other words, if you go back to the trend line [indicating], you will see a relatively sharp increase beginning in the last quarter of 1976 in the holdings of these liquid assets, which Mr. Sherman has been describing.

THE ADVANTAGE TO THE U.S. TREASURY

Senator CHURCH. You have described the advantage of this type of investment to the foreign central banks. What is the advantage to the U.S. Treasury of offering their debt obligations for sale in this manner, in effect, as it relates to the overallotments at a set price, to these foreign governments?

Mr. SHERMAN. The Treasury's obligation with regard to debt management is to finance the deficit, refinance the maturing securities, to do it fairly and to do it at the lowest possible interest cost to the public, to the taxpayers, and to do it in the manner that has the least possible impact on the economy and the financial markets. Regarding debt management they have discretion as to how to do this.

So, from their point of view, this is a very prudent procedure because they are placing the securities amongst presumably final investors. These countries are accumulating reserves at such a large or rapid pace that it is difficult to see them having a need for the dollars.

So, they are placing the securities among final investors. They are frequently placing relatively intermediate-term securities—2-year to 10-year notes—which is favorable and which means they will not have a refunding problem in the very near term. They are doing it at a price that is determined by a fair public auction.

So, the Treasury is getting a large part of its job done very successfully. If these securities had been sold in the public market, the public market would have had to have found a procedure for distributing them. That, of course, is our job. I have no question in my mind that we would do so. But it reduces the burden of debt management from the point of view of the Treasury.

Senator CHURCH. This is convenient for the Treasury and it assists it in the debt management?

Mr. SHERMAN. Yes, sir.

INTEREST RATE BEING PAID

Senator CHURCH. About what rate of interest is currently being paid to these central banks on the Treasury bills and notes? Can you give us a range of interest that is currently being paid?

Mr. SHERMAN. Yes, sir. I would be pleased to.

In the 2-year maturity range, yields are currently running at about $6\frac{5}{8}$ percent. In the 4-year maturity range, the yields are currently running around $6\frac{7}{8}$ percent. In the 7-year range, it is currently running around $7\frac{1}{8}$ percent.

Obviously these vary from day to day, but that is the approximate range of yields currently and those are the maturities at which most of the securities have been sold.

INTEREST/INFLATION

Senator CHURCH. Given the rate of inflation we have been experiencing, these interest rates do very little more than keep up with the pace of inflation—in fact, they may not quite keep up with it. They are very close to the rate of inflation in this country. So, the interest rates really constitute not much more than maintenance of value, isn't that about right, given the present inflationary rate?

Mr. SHERMAN. Yes.

The yield is giving them a very small "real" rate of return. It is still positive. The rate of inflation is running, we estimate, in the 5½ percent to 6 percent range now.

Senator CHURCH. In the United States.

Mr. SHERMAN. In the United States; yes.

Senator CHURCH. So their real earnings are very small?

Mr. SHERMAN. That is correct.

THE SECONDARY MARKET

Senator CHURCH. These foreign central banks could unload the Treasury bills, notes, and bonds in what you have called the secondary market. Can you explain just what is meant by that secondary market for the record?

Mr. SHERMAN. Yes. I would be very pleased to do so.

I have added into the record some charts, and I believe you have copies. It would help in understanding if you would follow me along with these charts. These were charts that I had prepared for my presentation next week at a talk I am going to give at the IMF meeting. They certainly serve the purpose.

There are two charts: one is "Quarterly Positions" and the other is "Daily Trading Activity Among Primary Dealers." (See appendix for charts.)

If you will, let's focus on the "Daily Trading Activity" chart. You can see that there has been a huge increase in daily activity starting from about mid-1975 or the fourth quarter of 1975, and continuing on. By the fourth quarter of 1976, daily trading activity was \$17.3 billion. Mind you, this is daily trading activity. There are days when it was substantially more.

For example, on the day in April, when the President announced his proposal to cancel the rebates, I understand that that 1 day's trading was as much as \$37 billion, just among the primary dealers, the dealers that report to the Federal Reserve. There are 34 primary or reporting dealers. Of course, there are many, many other participants in the market who trade amongst themselves and who completely bypass the dealer market. So this is a huge market.

In the second quarter, daily trading activity had fallen somewhat, so we were at a little over \$14 billion every day. But even despite the decline, it was still the third highest quarter ever.

If you will look at the category called Governments over 1 year, which are essentially notes and bonds, you will see that the daily trading activity in the fourth quarter of 1976 and the first and second quarters of 1977 exceeded in activity all of the bill trading prior to the third quarter of 1975.

So, we argue and tell central banks that the notes and bonds are almost as liquid as we used to consider bills to be.

Senator CHURCH. This is a very active trading market.

Mr. SHERMAN. Very active. Huge amounts can trade.

HOW MUCH DEALERS HOLD FOR THEMSELVES

The other chart, "Quarterly Average Positions of Primary Dealers," shows how much the dealers hold for themselves, where deals in all transactions are for our own account. We sell out of our own position; when we buy, it is into our own position.

You can see that dealers, even in times when interest rates are going upward—for example, in the second quarter, still held almost \$9 billion of Treasury securities, agencies' and money market instruments—and the bulk of it is Treasury's.

So, we think that the market is very able to undertake large transactions every day with a minimal amount of ripple.

Senator CHURCH. So you have a large, active, and healthy secondary market?

Mr. SHERMAN. Very much so.

THE OVERALLOTMENTS AND OPEC

Senator CHURCH. Going back to these overallocments being purchased by the OPEC governments, what has been happening? Have they appeared in the secondary market?

Mr. SHERMAN. No.

Senator CHURCH. Are they being sold into the secondary market or are they being held?

Mr. SHERMAN. We do a fair amount of business with foreign central banks. This has been an active part of our marketing program for well over 2 years, and so I can speak with some knowledge as to what the central banks are doing.

We have not seen any secondary market selling of these issues that we call overallocments or add-ons. There has been occasional selling of Treasury securities by foreign central banks, but it has been very small and most of the time the selling is on a swap. They sell one issue and buy another.

On balance, the central banks have been buyers of Treasury securities by far in the secondary market. This is completely apart from the overallocments or the add-ons.

To answer you specifically, we have seen no secondary market selling of the securities that have been added on to the public offerings.

WHAT WOULD HAPPEN IF OPEC LIQUIDATED HOLDINGS?

Senator CHURCH. Given the liquidity of these holdings, you said that they now amount to some \$60 billion, by foreign central banks, and the comparable liquidity of the add-on, what would happen, given the nature of this market, if these OPEC governments were to decide suddenly to liquidate their holdings, to resort to the market and to sell their Treasury bills, notes, and bonds?

Mr. SHERMAN. Senator, that is a very conjectural question. We would have to assume that they would be working against their own

self-interest because if the amounts were large enough, they would not only damage the price of their securities, they would damage the value of the dollar. Presumably, if they are selling Treasury securities, it is because they want to get out of the dollar and go into another currency, and so they would be hurting themselves twice in the price of the security and then in the value of the dollar vis-a-vis other currencies which presumably they might switch to.

To get into it more technically, it would depend really upon the state of the market at the moment, or market conditions, and the amount of securities they would want to sell.

In a reasonably flat market, they could move \$100 million of notes in a day with one dealer with no difficulty. We would be able to undertake such an order.

"BUTCHERING" THE MARKET

In a rising market, if they were to give the market 2 or 3 days to work and not "butcher" it, which I will describe in a moment, they could probably move \$1 billion in 2 or 3 days.

What I mean by "butchering" is this. Suppose one central bank decides that it wants to sell \$400 or \$500 million at one time.

If it goes to one dealer and works exclusively with him and he says that he has \$400 or \$500 million he wants to sell of a certain issue, how shall we do it, the dealer will work with him. He will take an order and do it on a best efforts basis, or will work it out over a 2- or 3-day period.

If, in contrast, the seller were to be unsophisticated and go to three, four, or five dealers at the same time and say, "You bid on \$400 million or \$500 million of a particular note," it would appear that there were really \$2 billion for sale, if he went to four dealers, and he would, as we say, "butcher" the market and the prices would go down very quickly.

Senator CHURCH. So, you would not anticipate that there is much danger that these governments would dump their securities onto the secondary markets because it would work against their own interests?

Mr. SHERMAN. It would very strongly work against their own interests. Our experience in dealing with them is that they are prudent, they are very conservative, and they are very concerned about the value of their securities and the value of the currency in which they are investing.

Senator CHURCH. Senator Javits, do you have any questions?

COMMENTS BY SENATOR JAVITS

Senator JAVITS. Thank you, Mr. Chairman.

I think the Chair has brought out what I had in mind, to wit, why is this harmful, why isn't it a good policy to take a ride on the back of what is an interest rate established by the market, especially as it tends to be a lower interest rate, and that is good for the whole economy. What is wrong with it? It is a very interesting phenomenon, but what is wrong with it?

THE COMMERCIAL BANKS

Now this is quite apart from the way we are handling the global problem of what the commercial banks are carrying, which worries me very much.

Senator CHURCH. Yes, this is a very specialized case.

Senator JAVITS. Exactly.

WHAT IS WRONG WITH THE POLICY ?

Now what is wrong with it? It is interesting to you, as a technician, and interesting to us to know what is going on, but what is wrong with it?

Mr. SHERMAN. I think it is a very good policy from the Treasury's point of view. We have never objected to it. As a taxpayer and a citizen, I think they are doing the right thing. From the point of view of the secondary market, the more we see in the secondary market, the better we like it; but we recognize that the Treasury's obligation is, as I described before, to get the debt financed and to do it at the lowest possible interest cost to the taxpayers, and to do it with the least possible disruption to the economy and the financial markets, and they are doing it in this procedure.

So, we have raised no objections with this.

Senator JAVITS. Well, I think that is the complete answer—it is a piece of the picture. I think you have given the answer: under present circumstances, where all they will get by competitive bidding is higher interest rates. It is not a bad idea.

Mr. SHERMAN. I would not automatically assume that they are getting these at lower interest rates, because if the Treasury did not have these special arrangements with the central banks and forced them to compete competitively the same as any large bank, or the same as we must, they would have to come to us or to some other dealer and say, "What do you recommend we bid at; what price or yield in the auction?" They might miss. But we would know that there is a buyer as soon as the auction is over and they find out they missed. So we would adjust our prices, our ideas in the auction, to reflect the knowledge that after the auction is over there is a buyer for \$500 million. So, I think when it is all over, the prices would not be terribly different one way or the other. But at least the central bank has an assured investment at a fair price perceived by all to be fair—it is established by a large, broad market. From our point of view, even though we missed the secondary activity, there is plenty of secondary activity going on anyway, as the charts demonstrate. We have never raised an objection to this procedure.

THE UNITED STATES IS HOLDING THE BAG

Senator JAVITS. It seems to me that the only thing that is really wrong with it is that the U.S. Government becomes obligated for these vast amounts of funds. We are facing a monumental—the Chair and I both feel this—and extremely dangerous problem because we are

holding the bag. We are holding it for the developing countries; we are holding it for the developed countries; we are holding it for the commercial banks. By we, I mean Uncle Sam. This very, very much concerns me.

UNITED STATES LENDER OF LAST RESORT

Mr. SHERMAN. Yes, Senator. In this environment, the United States has become the lender of last resort for all purposes.

Senator JAVITS. For everybody.

Mr. SHERMAN. Yes.

Senator CHURCH. Yes, that is the very point I wanted to make.

This is all very jolly, except that it demonstrates that the recycling of petrodollars is coming to us, and I suppose to some extent to other wealthy industrial countries, to their banks and their treasuries. Then it is up to us to extend the credit increasingly through the commercial banks to the debtor countries, the Third World countries. We are left holding the bag. We are obligated to repay these Treasury bills, notes, and bonds to the OPEC governments with large surpluses that continue to mount with each passing year.

We lend the money to the debtor countries so that they may buy the oil and other imports and we are left in an exposed position.

Is that not correct?

Mr. SHERMAN. May I discourse on that for a moment, Senator, please?

Senator CHURCH. Please do.

Mr. SHERMAN. In the 1950's and 1960's, the United States bought up a great deal of capital equipment and plants around the world, in Europe, Canada, and Latin America, and we paid for it with Treasury bills. Now we are buying up a lot of oil and are paying for it with Treasury bills, notes, and bonds.

There is always the philosophical question of who is in the stronger position, the debtor or the creditor. I am not endorsing continuing balance-of-payments deficits or continuing Federal deficits that have to be financed. But the figures are so large that the flexibility that the OPEC holders have is reducing.

Senator CHURCH. Yes.

WHEN THE POOR CAN NO LONGER PAY

I am not so worried about the relationship between the United States and the OPEC countries. What worries me is what happens when the poor governments, the governments of the lesser developed countries are no longer able to finance their mounting deficits. There comes a cracking point here and if they are not able to repay their debts to this country, to our commercial banks, then you have created a condition that could lead to the collapse of the international credit system.

From what we can determine, there is not any end in sight right now to the further accumulation of deficit by these poorer countries.

The United States is in the most exposed and most vulnerable position because it is the principal creditor.

If this picture were not triangular, I would not worry so much about it, because it is true that the more investment that Saudi Arabia

makes in the United States, the greater stake it has in the stability of our economy and the less motivation it has to tamper with the delicacy of the credit structure. It would continue, I should think, to handle its money in a very prudent and cautious way.

That is not just a bilateral relationship that we are concerned with; it is a trilateral one.

Mr. SHERMAN. Yes.

Senator CHURCH. And that I think we will get into when we have Mr. Solomon's testimony. He is our next witness.

THE AMERICAN EXPRESS STUDY

I want to mention one set of figures to which I referred in my opening statement.

One study shows that last year, as I recall, a fifth of the money that was borrowed by these developing countries had to be used for debt repayment; that this year a fourth of their borrowings will have to be used for debt repaying; and that by 1980 a half of their borrowings will have to be used for debt repayment.

Now, when economists talk about borrowings for the purpose of development of economies to make them more productive and thus more creditworthy, they don't always take into account that this mounting debt service is preventing these poor countries from investing in developments that make their own economies more productive and more creditworthy.

When you reach a point, if this study is accurate, where half of the money borrowed is simply necessary to roll over old debt and most of the rest of that money is then going to purchase imports, there is very little left, if any, for real investment. You are going to reach a cracking point. The first domino is going to fall here, somewhere and someplace. Though that may be a Cassandra-like prediction, at least it is being taken seriously enough that we have today our next witness explaining an attempt through the IMF to deal with this problem over the next 3 years. International efforts are proceeding at a rather frantic pace to prevent that first domino from falling.

THE WITTEVEEN FACILITY A "BAND-AID"

I agree with Senator Javits. I hope this committee will support the Witteveen Facility because I believe international conditions have made it necessary. But it is a band-aid. The most we can expect of it is some relief for the next 3-year period. We must hope that it will work for that length of time. But we are not dealing with the underlying disequilibrium in the world occasioned by the artificially high prices of oil and the huge surpluses that are being created. There is no end in sight.

Senator JAVITS. That's the point, Mr. Chairman. It is cumulative.

Mr. SHERMAN. May I address these points, please?

Senator CHURCH. Certainly.

Mr. SHERMAN. Obviously these conditions are apparent to us at Merrill Lynch, and I raised very similar questions to the ones you have just raised now within our firm.

THE GROSS NUMBERS

There are several aspects to this. If you look at the gross numbers, they are horrendous, because the interest cost overpowers everything else. The problem could become acute in a period of very high interest rates. If we were to return to a situation such as existed in July 1974, when interest rates were at double-digit levels, there would be real rollover problems because the banks would be tight, they would be reluctant to rollover, and the interest costs would be very much higher because the loans are made in many cases on a floating basis, and so the interest costs would automatically rise with the interest rates.

Barring that extreme, we then looked at the breakdown of who are the debtors. When you do that, the situation does not look nearly so bad. There are about eight countries which are huge debtors, but they are the ones who are best able to cope with it, such as Taiwan, South Korea, Brazil, where they have growing economies.

The weaker countries of the world for the most part are getting noncommercial credits—they are getting IDA-type credits—which are recognized as long-term-type loans.

The thing that must be avoided is financing long-term debt with short-term credits, as were the problems in New York City, to which you earlier referred, and some other commercial operations that also got into trouble.

The need for the Witteveen Facilities concerns the intermediate-sized countries that have real balance-of-payments problems and are too large to be financed through the commercial sources.

But we were not quite so alarmed once we looked at the individual country breakdowns and the nature of those breakdowns.

Senator CHURCH. We are going to look at some of those individual country breakdowns in the course of these hearings, so that we have a more thorough understanding of this whole problem. That is why we are taking these 5 days of hearings, to consider the Witteveen proposal against the background that we have been discussing of international finance and the mounting debt problems.

Are there any further questions of this witness?

Senator Sarbanes?

Senator SARBANES. Thank you, Mr. Chairman.

CAUSES FOR CONCERN

I just have one question, Mr. Sherman. Is there anything about the current situation that causes you—well, not “alarm,” but deep concern?

I take it that you think the U.S. position is so heavy, so to speak, that it is outside the normal constraints. In other words, creditors are almost held hostage to the debtor in that situation, rather than the other way around. But is there anything about the situation that causes you concern?

Mr. SHERMAN. No, Senator.

AN OPTIMISTIC OUTLOOK

Actually, we have been rather optimistic on the outlook for the next 18 months or so. We think the U.S. economy is in reasonably good

shape and will continue to grow. We think inflation is still high, but not moving to the double digit proportions we saw in 1974.

Central to all of the concerns that might arise would be the rate of inflation. As long as we can restrain the rate of inflation and undertake fiscal and monetary policies that are oriented in that direction, to restraining the rate of inflation, we feel that the conditions can be resolved through normal market procedures, innovation where necessary, which the market has been able to perform, and just sound banking and financing practices.

EFFECTS OF COMMERCIAL LENDING

Senator SARBANES. What about the extent of commercial lending that is taking place to some of the lesser developed countries in order to enable them to finance their situations?

Mr. SHERMAN. I'm sorry, Senator, but I didn't hear the last part of your question.

Senator SARBANES. What do you think about some of the commercial lending that is taking place with the lesser developed countries in order to enable them to finance the economic situation that they are in?

Mr. SHERMAN. Well, I am not a commercial banker, and I am not that close to it. But, from what I am able to gather, the commercial banks have been curbing the amount of commercial credit they are providing to the less developed countries. That is one of the reasons why there is more demand for such as the Witteveen Facilities, with which I concur with Senator Church, that it is not large enough.

So, I believe that the commercial banks are becoming more concerned and are recognizing that they have extended themselves as much as they probably ought to, and from here on in the growth ought to be in pace with the growth of the economies and the growth of the banks, and they are accumulating loan loss reserves. I think the banks are getting a heavy sprinkling of prudence along these lines, now.

TROUBLE AHEAD

Senator CHURCH. May I just make a comment. That, to me, seems to be the crux of the problem. The banks are about loaned up when it comes to further extension of credit to these governments, and the public lending isn't nearly large enough to fill the gap.

So, there is a crunch out here ahead, no matter how you look at it. Either it is going to mean that credit will not be made available to meet the needs of the Third-World countries, which spells trouble, or the banks, in conjunction with the IMF and other public lending institutions, will continue to provide the credit for a burgeoning debt that in the end cannot be repaid, which spells trouble.

Mr. SHERMAN. Yes.

Senator CHURCH. So, whichever way you want to look at it, it looks to me as if there is trouble ahead.

Mr. SHERMAN. Once again, the trick is not to finance long-term debts with short-term credit.

Senator CHURCH. I hope there is a trick that works.

DIFFERENCES BETWEEN 1950'S AND NOW

Senator SARBANES. What about the difference you draw between the situation in the 1950's and 1960's? Then what we were financing was capital investment in other countries, which remains as an asset and provides a return over the life of the asset. Now we are financing oil purchases, which may do some of that, but far less, I would assume, than was the case with the nature of what the debt being incurred was financing at an earlier period of time.

Mr. SHERMAN. There is no question but that you have put your finger on the difference. We are financing now a consuming asset instead of an income-producing asset.

Senator SARBANES. But shouldn't that be a cause for concern?

Mr. SHERMAN. Yes; it is. Our hope, our strong hope, is that we get an energy policy that orients us away from heavy consumption of imported oil.

OUR ENERGY POLICY LIKE WATCHING GRASS GROW

Senator CHURCH. Well, whatever kind of energy policy we get for ourselves, that does not extend to all of these developing countries. They are going to have to do the same. Besides, none of this can happen very fast.

Mr. SHERMAN. That's correct.

Senator CHURCH. Watching us become energy self-sufficient is like watching grass grow. [General laughter.]

Senator SARBANES. And in the desert, sometimes. [General laughter.]

Senator CHURCH. If we can't do any better than that, then I don't know how the other poorer countries will manage.

Mr. SHERMAN. These less developed countries have had problems before the oil crisis, but it has gotten worse with the oil situation. There is no question about that.

Senator CHURCH. I want to thank you for your testimony and for the explanation you have given us of present Treasury practices. That has been very helpful.

It has been a good starting point for this hearing.

Mr. SHERMAN. Thank you, Senator.

Senator CHURCH. We are going to have just a short recess before we ask our next witness to take the stand.

[A brief recess was taken.]

Senator CHURCH. Our next witness is Anthony Solomon, Under Secretary of the Treasury for Monetary Affairs. Mr. Solomon, I wonder if you could highlight this statement; submit the whole statement for the record but summarize it in your own words for the committee so that we can get to questions more quickly.

STATEMENT OF HON. ANTHONY SOLOMON, UNDER SECRETARY FOR
MONETARY AFFAIRS, DEPARTMENT OF THE TREASURY

Mr. SOLOMON. I anticipated that, Mr. Chairman, and I do have a shorter summary I would like to run through; otherwise, I might miss something.¹

Mr. Chairman, I want to say first how much we appreciate your scheduling this hearing at an early date. The Witteveen Facility—the

¹ See p. 157 for Mr. Solomon's prepared statement.

IMF supplementary financing facility—is extremely important to the world economy and the international monetary system, and our participation is essential if it is to come into being.

So it is important that we move as quickly as we can in considering our participation, and your hearing today is a very welcome contribution to the process.

I have submitted a formal statement to the subcommittee. If I may, I will just summarize that in my remarks here today.

The international monetary system at present faces certain potentially serious problems. The supplementary financing facility is needed, and urgently needed, to strengthen the International Monetary Fund and to enable us to deal with these problems.

The establishment of this facility will help to make sure that our international monetary system continues to function smoothly and it will further in an important way our objectives of an open and liberal system of international trade and payments.

Much of the relative prosperity which the world has enjoyed over the past 30 years derives from the strength and effectiveness of our international monetary system with the IMF as its principal instrument. That system has provided the framework for a growth in world trade and financial flows unthinkable at the time the IMF was established.

No nation has benefited more than the United States. Our foreign trade amounted to \$235 billion last year, nearly 15 percent of our gross national product. Our exports provide one out of every six manufacturing jobs. Essential imports are integrated into all phases of our economic life.

Our currency is widely used internationally and widely held and our capital markets channel vast sums to investment throughout the world. Our efforts to promote growth, reduce unemployment and curb inflation depend on an effective international monetary system.

The monetary sphere is one area in which international cooperation has operated with a high degree of success. We have on a number of occasions modified and adapted the system to meet new problems and new circumstances. The supplementary financing facility is a further such step, an important step to meet a serious present need arising out of drastic changes in the pattern of international payments in recent years.

Since 1973 there have been international payments imbalances of unprecedented size resulting from the massive oil price increases, deep world recession, and rapid inflation. This has placed serious strains on the system. With the recognition that these imbalances could not be eliminated in the short run, emphasis was placed on financing the deficits.

Both official and private financing expanded sharply. The increase was spectacular. In the 5 years 1971 through 1973 the aggregate deficit of all nations in current account deficit averaged \$15 billion a year. In the 3 years 1974 through 1976 it was \$75 billion a year, a total of \$255 billion for the 3 years.

Nations have borrowed very heavily in the years 1974 through 1976 to finance their large balance of payments deficits. The borrowing took many forms. While official financing through the IMF during this period was far above historic levels, it was the private markets that handled the bulk of the financing, accounting for about three-quarters of the total.

Given the private market orientation of the world economy, it was natural that the bulk of this financing be handled by private rather than official channels. The question has been raised as to whether this rapid and unprecedented enlargement of lending activity and debt has reached a danger point for the monetary system, either in the sense that large numbers of countries have borrowed beyond their capacity to service debt or in the sense that our banks and other institutions are overextended.

It is our considered judgment that the system as a whole is not in any such position of imminent danger, either as a result of excessive borrowing by large numbers of debtor nations or as a result of our financial institutions' being overstretched.

But the fact that the system has, in the financing sense, worked well thus far is no cause for comfort or complacency. Success in the past is no guarantee that we are adequately armed for the period ahead.

THE SUGAR COATING

Senator CHURCH. May I interrupt. This is sort of a sugar-coated way of putting it. In the beginning the opportunity to develop a new clientele for the commercial banks looked very profitable, very attractive. When we went into the recession the ordinary demand for credit on the part of business, corporations, and so forth fell off.

The commercial banks found new customers. They found them in many foreign governments that had to borrow heavily to pay their oil bills. This looked good. The interest rate was high. The profits jumped up dramatically. Take the 12 largest banks. Their profit from foreign earnings increased—they must have doubled in that 3-year period and now are the equivalent of their total earnings from domestic loans.

So it looked like a great thing. Bankers had the feeling that foreign governments could not possibly renege because that would destroy their creditworthiness and they could not acquire more private capital; therefore it was a safe investment with interest rates and they plunged into this, \$75 billion worth of credit extended to these foreign governments.

Now all of a sudden, when you say just because things have gone so well in the past it is no cause for comfort or complacency, indeed it is not. Because all of a sudden you see these governments borrowing so heavily that their capacity to pay off these debts, as they have to, to acquire still more, is a subject of serious concern.

I don't take issue with what you have said; I just think the way you say it tends to suggest that this is a healthy situation. But, simply because it is healthy, we should practice some preventive medicine. I think the patient is pretty sick at this point or at least is suffering from a disease for which we do not know the permanent cure.

What you have come up with here is a palliative. It may result in another regression but the illness is going to come back; and though I am not opposed to what you propose—I don't know what else you can propose; I want to commend you for your negotiating this arrangement which for the first time brings the OPEC governments themselves in with sizable contributions; all of this is praiseworthy—still I must say that you are putting the best possible face on a situation that, I think, is very disturbing and for which we have yet to find anyone who can give us an adequate and long-term solution.

I am sorry; I did not mean to launch a tirade at you.

Mr. SOLOMON. Shall I continue, Senator?

Senator CHURCH. Yes; continue.

EXPECTATIONS FOR THE FUTURE

Mr. SOLOMON. Let me comment on our expectations for the future and how the supplementary financing facility fits into the picture.

Nations have approved the broad outlines of a balance-of-payments adjustment strategy. At the Manila IMF meeting last fall it was agreed that:

Adjustment should be symmetrical, reducing both surpluses and deficits;

Countries in balance-of-payments difficulty should shift resources to the external sector and bring current account positions into line with sustainable capital inflows;

Countries in strong payments positions should maintain adequate demand consistent with anti-inflationary policies;

Exchange rates should play their proper role in adjustment.

Looking ahead, it is nonetheless a safe prediction that large imbalances will continue for the next several years. We expect a reduction in the surpluses of the major industrial countries as these nations expand their economies in line with domestic needs and the agreed adjustment strategy. But we expect only a gradual decline in the OPEC surplus—which is the largest part of the imbalance—from the present level of about \$40 billion.

THE OPEC SURPLUSES

As is clearly pointed out in the subcommittee's recent staff report, the OPEC surplus does not lend itself to abrupt correction. It is structural in nature. The energy needs of the oil importing nations cannot be suddenly and sharply cut back if economic activity is to be maintained at acceptable levels, and adequate supplies from alternative sources do not at present exist.

The reduction and elimination of OPEC surpluses through curtailment of oil imports will take a period of years. It is important, critically important, that the United States and other oil importing nations apply stringent measures to conserve energy use and expand energy production. President Carter's program will make a major contribution to an improved energy balance. But our program and those of others cannot yield major reductions in oil imports overnight.

Similarly it is not realistic to expect, in the relatively small number of OPEC nations in which the surpluses are concentrated, too rapid an increase in purchases of foreign goods and services.

LARGE IMBALANCES TO CONTINUE

Accordingly it must be expected that large imbalances will continue at least for the next few years while we work toward their elimination. In the meantime our efforts must be directed toward assuring that the collective current account deficits are distributed and, to the extent possible, reduced so that the necessary borrowing is undertaken by those countries whose creditworthiness and economic strength are adequate to sustain the additional debt.

The supplementary financing facility is a major element of our strategy for fostering this needed adjustment and helping to assure such a sustainable pattern of payments.

With the establishment of the supplementary financing facility there will continue to be a large amount of borrowing, private as well as public. Concern has been expressed that continued borrowing in very large amounts, irrespective of who is borrowing or how the credit is used, constitutes a serious danger for the monetary system.

I do not share that view. If the borrowed funds are properly used to support productive investment and to strengthen the borrower's current account position, the debt need not constitute a serious future burden, as shown by the experience of the United States in the last century and other countries at present.

Excess savings in surplus OPEC countries can, in effect, finance investment in the oil importing countries by supplementing domestic savings. But the borrowed funds should be productively invested in order to avoid servicing problems in the future.

This, then, is the broad strategy within which the supplementary financing facility fits: We aim for a sustainable pattern of payments in which the borrowing is undertaken by countries commensurate with their creditworthiness; we seek to assure that the borrowed funds are used to support sound and effective programs of stabilization and adjustment; and meanwhile we work toward elimination of the oil imbalance through energy programs and further development of the OPEC nations' capacity to import.

The supplementary financing facility will thus help to assure that needed financing is available and that adjustment measures are adopted. Much adjustment remains to be done. Structural changes, domestic and external, must take place in many countries, often involving major alterations of traditional patterns of production and consumption.

Such changes will not come easily and must take place over a number of years if satisfactory levels of growth and employment and an open system of trade and payments are to be maintained. Substantial financing will continue to be needed by countries in deficit. And in some countries adjustment measures need to be introduced.

LIMITS TO BORROWING

Clearly there are countries—certainly not a large number but a significant number—that have already reached or are approaching the limits of their ability to borrow or their prudence in doing so. These are countries that are beset by internal economic imbalances, that still face large payments deficits, where the need for corrective measures and internal and external adjustment is compelling.

Such countries—and others which may in the future face similar difficulties—must be encouraged and permitted to adjust their economies in ways that are compatible with our liberal trade and payments objectives, in ways that avoid discrimination against others and disruption of the world economy. A major function of the IMF is to induce such adjustment.

Given our expectations, it is essential that the resources of the IMF be adequate both to enable it to foster responsible adjustment policies by members facing severe payments difficulties and to provide confidence to the world community that it can cope with any potential problems that may arise.

Without the additional funds of the new facility, the IMF's resources may not be adequate to meet demands placed on it over the next several years. Its resources—some \$5 billion now, perhaps \$6 billion to

\$7 billion more when the already agreed quota increase becomes effective and remaining commitments under the general arrangements to borrow of about \$3 billion—look sparse in a world in which total imports are running at an annual level of nearly a trillion dollars and in which OPEC surpluses are likely to decline only gradually from the current \$40 billion annual level.

THE WITTEVEEN FACILITY

Against this background the decision was taken—against, I might say, the failure of the financial support fund of the previous administration to be acceptable to this Congress—the decision was taken to seek to establish the supplementary financing facility as a temporary measure and with financing of about \$10 billion to be provided initially by seven industrial nations and seven OPEC countries.

The industrial countries would provide \$5.2 billion, of which the U.S. share, subject to congressional authorization, would be SDR 1.45 billion—about \$1.7 billion—approximately 17 percent of the total. The OPEC members would provide about \$4.8 billion, or nearly half the total, with Saudi Arabia the largest single participant of either group, at \$2.5 billion.

The terms relating to the provision of this financing to the IMF by the participants are presented in detail in the National Advisory Council special report on the supplementary financing facility presented to the Congress with the legislation. My prepared statement also goes into some detail on these terms. I would make three main points here:

ADVANTAGES OF THE FACILITY

First, U.S. participation in the facility is advantageous to us not only because of the general benefits to us of a strong world economy but because, in exchange for our financing, we received a strong, liquid, market-interest claim on the IMF.

Second, the facility is designed to help in the cases of countries with very serious difficulties and very large financing needs. It will require serious efforts by borrowers to correct their problems. But, in comparison with regular IMF resources, it will be able to supply larger amounts of financing while they initiate adjustment programs. And it will permit them somewhat more time to adjust in recognition of the very severe problems they face.

Third, the facility is a cooperative venture, with the surplus countries of OPEC and the stronger industrial countries joining together to assure that the needed financing will be available.

The agreement requires that, before the facility can begin operations, participants must formally commit \$9 billion of the full \$10 billion and the six largest participants must all formally commit themselves to participate. Thus, action by the United States and the Congress is necessary before the facility can become a reality.

QUESTIONS CONCERNING THE FACILITY

Let me address three questions which have been asked with respect to this new facility:

First, how can we be sure that the \$10 billion contemplated for the facility is adequate to do the job but not more than is needed?

Obviously it is a matter of judgment and no one can be absolutely sure. We cannot predict with certainty just which countries will have the particularly large needs for credit that make them eligible for this facility along with the willingness to adopt the kind of adjustment programs associated with it.

It is our judgment that this facility plus the amounts available to the IMF from other sources will enable it to provide financing over the next 2 or 3 years up to, say, a total of \$25 billion. This is above the levels of IMF financing of recent years, which were already relatively high.

To assure confidence in the monetary system it is vital that the IMF always be known to have adequate resources in reserve to meet whatever urgent problems may arise even if it turns out that less than the full amount is actually drawn.

Since no cash transaction occurs until a member country actually draws from the IMF, there is no interest or other cost whatever—to the IMF or to the United States and other participants—for any portion of the facility not actually utilized for drawings.

A second question is: Will the facility serve to “bail out” private banks which have lent unwisely or excessively?

The answer is: No. The facility is not so designed and will not be so used. It will not bail out either countries or banks. It will encourage countries to initiate needed adjustment measures before their debts become too large to handle or credit is no longer available, and it will provide transitional financing while the measures take effect. It will help redistribute deficits to a more sustainable pattern and improve nations' creditworthiness and confidence in the monetary system.

It is not a substitute for bank credit and will not take over the banks' regular lending activities. While IMF financing may in the period ahead account for a share of total balance-of-payments financing larger than the 7 percent it provided in 1974 to 1976, it will remain small in comparison with the share channeled through private markets.

In fact, the facility is expected to encourage banks to continue to expand their foreign lending rather than cut back, by promoting sound economic policies on the part of borrowers; and historical experience indicates that, in fact, the banks normally lend more to a country after it has entered into a stand-by agreement with the IMF.

The banks will benefit from the new facility but only indirectly—through the improved international environment, stronger monetary system and high levels of trade that will benefit all elements of the American economy.

A third question is: Why was the supplementary financing facility established rather than the alternative of a permanent change in IMF quotas?

The answer is that this method was chosen for reasons of timing and practicality. A review of IMF quotas is underway; but, with the complications of negotiation and ratification, it may not lead to actual quota increases for, say 2 years or more.

Hopefully the new facility can be put into operation at an early date and cover the particular needs until a quota revision occurs. The facility is also more flexible than a quota increase since it is not subject to the same quota constraints that individual countries draw and can

be used more selectively to meet the problems of countries with particularly large needs.

ADMINISTRATION URGES ADOPTION OF FACILITY

Mr. Chairman, the IMF is a valuable institution, in which all members contribute, financially and otherwise, to an effective international monetary system. It has a good record. The proposal for a supplementary financing facility is a sensible and realistic way to strengthen it to meet present problems. The facility is equitable to all parties. It is needed and needed soon.

The administration urges that the committee report the proposed legislation favorably and that the Congress enact it promptly. I thank you.

Senator CHURCH. I am first going to turn to Senator Javits, who has another engagement. Then I will turn to you for such questions as you would like to ask before I start questioning. We will reverse procedures.

CORRECTIONS ON THE CHARTS

Before doing that, Jerry has a correction he wants to announce with regard to one of the charts.

Mr. LEVINSON. On table 2 total, placement by oil exporting countries 1974-77, which has been handed out, in paren we show for Middle East total banking portfolio security placements by Middle East oil exporting countries to the United States, and in the foreign branches of major U.S. banks we show in paren a figure of \$16.7 billion and Treasury notes, bills and bonds in the United States, that figure should be \$12.7 billion. We double counted it.

And \$12.7 billion is still not a small amount but I wanted to make that correction for the record. The correct figure is \$12.7 billion rather than \$16.7 billion.

Senator CHURCH. Senator Javits.

REMARKS BY SENATOR JAVITS

Senator JAVITS. I want to express my gratitude to Senator Church for turning the order completely upside down as I have a number of other committee meetings, and I should be quite brief.

May I say first that I have great sympathy with Treasury, which takes a position far more optimistic than Senator Church and I have taken. You are doing what you have to do and we are doing what we have to do. As I see my role—and Senator Church is extremely well able to speak for himself—we have to use a certain amount of shock treatment with the world, which is inclined to be complacent in the face of what I personally consider an extremely grave danger.

DEEP CONCERN IN NATO COUNTRIES

I hope you were here, Mr. Secretary, when I said in Europe—where I just came from last night—I found by the parliamentarians of the various North Atlantic Treaty Organization countries a similar deep concern, a very healthy respect for the danger. So I don't feel alone, or isolated in my view.

Now, I find a very interesting piece by M. S. Mendelson in the American Banker, September 15, 1977, analyzing this very subject, Mr. Chairman. I ask that it may be included because I would like, after deliberation, for the Treasury through Mr. Solomon to respond.¹

Senator JAVITS. I would like to direct your attention to one thing. It deals with the rationale by which we think everything is going to be all right. He may be wrong about our rationale, but the theory is: If Western economy slowed down, we have surplus money to lend so our banks are doing OK. If they cannot lend it here they will lend it there.

On the other hand, if Western economies speed up, then they have export income and that reduces the need for their borrowing, so there is kind of an automatic adjustment to the ebb and flow.

The difficulty with that theory is: It fails completely to take account contingencies—increase in price of OPEC oil, particular pressure in particular places because of political situations in those places, the burden of debt becoming so great compared to developmental needs—that is, Brazil—that a situation which looked very good in credit terms may not look so good at a given time and the fact that if anything gives in the world, whether it is another Herstatt Bank or Franklin National, it is likely to bring the whole thing down with it.

I think it would be necessary because, as I said before, no confrontation between myself and Treasury; we are simply trying hard to protect our country and the world, and our difference in view will have an effect on each of us and that is all I am trying to say.

BANK LENDING AND FOREIGN POLICY MATTER

Mr. SOLOMON. Senator Javits, could I make one comment. I read the Mendelson article. Although I agree with some of it, he makes a much larger point which I am not sure you would agree with any more than we. He says that when private banks lend to foreign governments, this becomes a foreign policy matter and therefore is it appropriate for foreign policy to be handled by private banks?

Now, I think that is carrying the concern a little too far in my personal view because if you start looking at the economic system that way almost anything becomes a foreign policy matter and the implication is that the Government should then control all forms of lending to sovereign governments. I don't feel that is the gist of your concern. Am I correct?

Senator JAVITS. I think you are asking me a legitimate question and my answer is it is not the gist of my concern but an important element of my concern because of the volume involved and the lack of any other backup. There is no other reserve than either the individual governments or the international financial institutions and if you really scratch beneath the surface you find that our banks really in the final analysis believe that. They believe their loans are perfectly secure because ultimately the international financial institutions or the U.S. Government, through the Federal Reserve cannot let these things go very sour.

That, by the way, is disclosed—and I will put it in the record, Mr. Chairman—in an earlier monthly letter of the First National City Bank of New York in which they say it frankly. So that is why I am worried.

¹ See p. 183.

But I don't believe the banks can proceed considering their proper reason for action, to wit, profitable operation by banks, completely free of the governmental considerations which are political appraisals and political considerations and the conditionality which is infinitely better imposed in a more coordinated way by the IMF than it is by the individual banks.

So I believe that we have yet to develop in our system, some technique by which neither party simply is going to proceed without referring to the other party. You know, they come down here and they talk to you and you know you feel free to talk to them but it is not quite the same thing. It is a worry of mine. Not the gist of my worry but it is a worry.

IS OUR SYSTEM IN DANGER?

May I ask you this: What you say on page 4 of your statement, to wit, "It is our considered judgment that the system as a whole is not"—you underline the word "not"—"in any such position of imminent danger, either as a result of excessive borrowing by large numbers of debtor nations or as a result of our financial institutions being overstretched." That is the policy of the administration. Is that correct?

Mr. SOLOMON. If you go on to supply the second half of it, which is that we feel that there are individual countries which have reached the limits of external borrowing where we feel that they need the kind of program that the Witteveen Facility and the fund would work out with them, we believe that under those circumstances, that there is no danger to the system as a whole.

I might even go so far as to say that debt rescheduling does not represent disaster for the system as a whole. It is confined to a few key countries, and if one looks at the record, there was much more debt rescheduling in Argentina, Brazil, Colombia, and Chile. The last few years it has only been Zaire.

I honestly don't want to be accused of complacency. We have a very serious problem. At the same time. I think one has to avoid talking in terms of dangers to the system as a whole which implies collapse, which I don't think is at all likely. I think that the present unsatisfactory limping along status is much more likely to be the reality of the next few years than either a marked solution—improvement in our economic situation on the one hand or collapse on the other.

PROBLEMS OF RESCHEDULING

Senator JAVITS. Again I repeat what I said before. You are doing what you have to do and we are doing what we have to do, and I have explained my purpose.

I would like also to point out that it is again a question of the amount. Rescheduling of Brazil or Mexico is going to be a lot more serious than a rescheduling of Syria and in view of the fact that you postulated heavily with no increase in prices and no material diminution of the recovery rate, no increase in oil prices, so that would worsen the accumulation of deficit, and you premise your judgment on that and no material interruption in the recovery. I think these are very chancy propositions, especially as you yourself predict the period of stagnation. You may not have millions of people holding still for all that. That is what we have to consider as politicians.

NO PROSPECTS OF RESCHEDULING FOR BRAZIL OR MEXICO

Mr. SOLOMON. Senator, may I make one point for the record. In my view, there is absolutely no prospect of a debt rescheduling in regard to Mexico or Brazil. And I would not want to leave any impression that there is.

Senator JAVITS. Neither do I. I don't want to leave any such impression, either. I am not looking for it.

Mr. SOLOMON. The current account deficit of Mexico has been cut this year to less than \$1.8 billion, more than a 50-percent cut compared to last year. Double digit inflation is being rapidly reduced from 30 percent—you know, Senator, you have been following this closely—with your current rate of inflation 12 or 14 percent, there has been major improvement in the Mexican economy. Unfortunately, not in the unemployment figures. But with the exception of that, there has been and Brazil is able to handle its debts quite comfortably.

Now, nobody can predict the future in the long run but I would say those countries are undertaking stabilization programs and have shown substantial improvement this year.

Senator JAVITS. Let's not erect strong men and knock them down. I did not make any such prediction to Mexico or Brazil and I repudiate it flatly. Don't put me in that position. I am not arguing that. All I am saying is, you assume no major debt rescheduling. These others are relatively minor. A major one would be a great shock to the international monetary system which I don't think it can stand. But I am not predicting it or anticipating it or even saying there is a grave danger of it. Don't put me on that spot. I don't deserve to be.

THE PREDICTED DEFICIT

One other thing I would like to ask you. Do we expect—projecting forward now, let's say just in round figures to 1981—that the accumulated deficit which we are going to be running which needs to be financed is just about what it has been, no more, no less, and your own figures indicate that that runs into the area of \$40 billion a year pretty steadily now.

Mr. SOLOMON. What are you referring to, Senator?

Senator JAVITS. What I am referring to are the imbalances which are created by the accumulation in the OPEC countries of—

Mr. SOLOMON. Which projections are you referring to?

Senator JAVITS. I don't want to refer to any official projections.

Senator CHURCH. But it has been for the last few years.

Mr. SOLOMON. I just wanted to be sure there of the set of figures you were thinking of, Senator. The question is, what exactly, how do we expect to handle this volume of an average of \$75 billion a year deficit if it should continue?

Senator JAVITS. That is not if it should continue. As I understand it, that is what your ideas are postulated on, that it will continue.

Mr. SOLOMON. We believe there will be a slight diminution. It is not going to be on a major order of magnitude but if you are talking up to the 1981 period, we do not see that there will be a major diminution in those figures.

Senator JAVITS. So in the 1981 period which, roughly speaking, is 4 years from now, we will be accumulating those deficits in the order of magnitude of \$150 to \$200 billion. This is the thing that worries me.

It is the cumulative effect and you are depending, as I understand it, upon two-thirds of that being financed by essential commercial sources.

HOW DEFICITS WILL BE HANDLED

Mr. SOLOMON. We are assuming that the rate, the bulk of it will be handled by the capital markets and there may be a slight increase in the fund's share. There may be a small decrease in the private capital markets and I would say that within the ball park that is it.

Senator JAVITS. The private bankers, commercial bankers, et cetera, who followed you in the testimony before Senator Stevenson's Subcommittee of the Banking and Bank Affairs Committee, did not indicate that they were quite ready to undertake that obligation. They indicated that they were pretty well loaned up and that they could not see very much more latitude as far as looking to them is concerned.

Mr. SOLOMON. As I read the testimony, Senator, they felt they were loaned up in regard to a few countries who had reached, in their view, the limit that they felt would be prudent to extend new loans to them. I did not believe them to make that as an overall statement.

Senator JAVITS. But nonetheless, didn't it give you some sense of disquiet that they could not be absolutely depended on?

Mr. SOLOMON. This is why we are proposing the Witteveen Facility in the case of a few key countries—not many.

REACHING THE WEAKEST LINKS

Senator JAVITS. Aren't you really saying that when a country has reached the limit of its creditworthiness, where the banks now have reason to fear the loans they have made will not be repaid or any further loans ought not to be made, or where their judgment has let them go too far, that this is where IMF comes into the rescue mission? It extends public credit which in turn enables that country to start repaying on private loans. You are really trying to get some extra public credit to reach the weakest links before they break.

Mr. SOLOMON. Let me put it this way.

Senator CHURCH. Is there something inaccurate in the way he put it?

Mr. SOLOMON. Only one phrase I felt would be inaccurate, which was this: That if a country will undertake a stabilization program with the help of the Witteveen facility, it will reduce its current external deficits. Its need for borrowing will be less, but even so, the Witteveen bidding facility, the funds resources, will not finance the entire amount of that new deficit, and in practice the record shows—and we would expect it to show in the future—that private banks will increase their credit.

CONDITIONALITY OF THE LOANS

Senator CHURCH. Then you are hoping that when you go to the rescue that in addition to supplying further public credit you can lay down austerity terms that will help the country correct its internal economic problems in such a way as to make it creditworthy again?

BRITAIN, ITALY, AND MEXICO

Mr. SOLOMON. Exactly. But, I would also say that the term "sensible policy involved in the stabilization program" represents more than

austerity. It is not just austerity. Take the three most important cases in the last year, Mr. Chairman, where countries have gone into the Fund, namely Britain, Italy, and Mexico. We have seen major improvements in their situation. They have done this certainly with an element of austerity but also with more sensible policies which have in a certain sense redirected some of these resources from consumption into borrowing. And, in all cases as well, a limit has been placed on the additional amount of new external borrowing worked out in negotiations between the Fund and the country involved. So the fact that it gets its house in order does not mean then it is open carte blanche to another bout of wreckless spending. It is working on a controlled program where it will limit and carefully control the amount to which it increases its debt to the private capital markets. I do not expect debts to private banks to be decreased as a result of the activation of the Witteveen bidding facility. On the contrary, with a good house-keeping seal of approval which the Fund gives we may find there is some modest increase in bank lending.

EXPOSURE OF THE UNITED STATES

Senator JAVITS. There are only three points I would like to make and I shall make them and then please comment because the Chair has been very indulgent. One is that I see a much greater exposure by the United States as more of these funds come into the United States and the record indicates as analyzed by our own staff—which I think is a splendid analysis—that we are getting an increased rather than reduced amount of placement in our country. In 1974, 21 percent of OPEC's funds were placed in the United States either in debt or in equity industries. By the first quarter of 1977, the placement increased to 35 percent of OPEC's investable surplus. So again, unless there is some real balance that the Treasury is looking at between the terms of what is being put up here and the opportunity to call it—and let's remember we had a 1973 embargo for strictly political reasons—you can have a 1978 embargo for strictly political reasons. Thus, we have a great, grave danger to the United States. That is one.

The next point that I would like to make is that you make the argument in your statement that the main borrowers are the OECD countries themselves and the big borrowing is not being done by the developing countries. So my question is why did we abandon the safety net if we have got that particular situation facing us?

DO WE NEED BETTER MACHINERY?

The third question which I have is, don't you think we need better machinery for the very purpose which we have talked about a little bit, to wit, the interface between our Government and our view of the political situation involved and the commercial banks in view of the fact that we are relying so heavily upon commercial sources to really finance most of this deficit?

Mr. SOLOMON. In answer and briefly, Senator, you put your finger on the first point, that even though the percentage of OPEC's investable assets that is coming in to the United States has increased somewhat—

Mr. LEVINSON. Could we refer to the chart which brings that out?

Mr. SOLOMON. It is 27 percent if I remember correctly to something close to 35 percent in the first quarter. On the other hand, it is worth

pointing out that in 1974 when you had 27 percent coming in, almost 90 percent of OPEC money—

Senator CHURCH. Twenty-one percent in 1974. The last grown from 21 percent to the present rate of 35 percent based on the first quarter of this year?

Mr. SOLOMON. In 1974, when you had 21 percent of OPEC investable assets coming to the United States and almost 90 percent of it went into short-term instruments of various kinds. In other words, bank deposits primarily and some bills.

In the last 2 years the percentage that is going into short-term instruments is running about 3 percent, or 3 to 4 percent. From almost 90 percent to about 3 to 4 percent. I can give you the exact figures. Now this means that even though this is an attractive market for the OPEC countries we do nothing to invite their money. We do nothing to push it out. This is the largest capital market in the world. We do not give them preferential treatment of any kind. They have found it in their interests to invest more here and they have found it in their interest to invest the overwhelming bulk of it unlike the first year in long-term industries.

WHY DID WE ABANDON THE SAFETY NET?

Senator JAVITS. The next question is why did we abandon the safety net in view of the fact you point out in your own statement the heaviest borrowers are the OECD countries and the safety net was developed for that purpose. Then everybody had agreed except us.

Mr. SOLOMON. First of all, even though the bulk of the borrowing has been done by the OECD countries the LDC's last year had a current account deficit of approximately \$16 billion. This year will be \$13 billion and these are not inconsequential amounts. Some of them as we know, are in a situation where they should come into the Fund and do a stabilization program. In addition, you have the nonindustrial countries, the lesser developed countries of the OECD. I don't want to mention countries specifically name by name but let's say that in the Mediterranean region you have a group of nonindustrial, OECD countries whom we expect would be heavy users of the Witteveen facility.

Now, the reasons for going from the financial safety net to the Witteveen Facility which the Congress itself required were threefold. One, they wanted OPEC contributions and we are getting rough equality now between OPEC contributions and industrialized country contributions.

Two, they wanted the funds, which has a long history of conditional financing, for balance of payments reasons to be using its expertise in this area rather than the OECD Secretariat.

And third, of course, to be available to all members of the Fund, whether developing, whether nonindustrial countries of OECD or even in a few cases, industrial countries of OECD.

So I think that explains fully why in response to the congressional concern with the financial safety net, why we devise a structure that would meet the objectives of Congress.

A BETTER FACILITY

Senator JAVITS. The last question is one about a more effective interface between the commercial lenders and our Government in view of the fact we are relying on them so heavily.

Mr. SOLOMON. I am not quite sure I know what you mean by that, Senator.

Senator JAVITS. What I mean is how can we make them also give some consideration to political and diplomatic policy. For example, it is my judgment—and it is no secret—that we have to lean very heavily upon the OPEC countries, and lenders through us. We are the obligated party and we must have a much more orderly, a much more long term, and a much more coordinated relation to our lendings than they do.

For example, we still have not gotten them very interested in investment in long term projections dealing with energy replacement. Yet they are going to run out of oil in 25 or 30 or 35 years and here could be an excellent investment helpful to us and the whole world.

As to the commercial lenders you know they are doing their thing and we are doing our thing in the Government. All I ask is, does the administration have in mind to have some better interface between the two?

Mr. SOLOMON. We do have certain things in mind, Senator. There are basically three tracks going on to establish better cooperation and interface. One track is that the Fund Board, the Board of Directors of the International Monetary Fund has been discussing to what degree and under what conditions it would be advisable to exchange information between private lenders; that is, to have a three-way exchange between private lenders, borrowing countries who are members of the Fund, and the Fund.

Now, they have the problem of developing an arrangement which does not violate the confidentiality of the data submitted to the Fund. These discussions have been underway the last 2 months and I would be reasonably confident that we will see some new first initial steps in cooperation emerging from this. This is not something that can be done in an arm-twisting way obviously.

QUALITY OF DATA

Now second, we also need for better interface more accurate information. As the staff committee report pointed out, the data available on international debt, particularly outside the United States, is incredibly inadequate, overlaps, and there is much double counting. We have an exercise going through the central bank in the BIS to acquire more accurate information, profile on each country's debt. In the financial field, and maybe in other fields, things move slowly but this is an exercise that is going on.

In the third track, the Federal Reserve, the Controller of the Currency, and the bank examiners, are now demanding on heavy borrowing much more detailed information or comprehensive information on bank lending abroad. Our records, our data are better than that of any other country, I would believe, from the data that I have looked at because most of the data on international debt has come from different studies done by the World Bank, OECD sources, sources that are different. The figures are not consistent and there is a substantial problem here. But we are encouraging these various institutions and the governments involved and it is not only the LDC governments.

These are some highly industrialized governments who refuse to report their borrowing abroad and this is a problem that has to be worked out with them.

Senator JAVITS. Thank you very much.
I want to express my gratitude to Senator Sarbanes and Senator Church.
Senator CHURCH. Senator Sarbanes.

THE CHANGING FIGURES

Senator SARBANES. Mr. Solomon, I am interested in the changing figures. In your statement you point out that the current account deficit in the period of 1971 through 1973, aggregate deficit of all nations, was averaged at \$15 billion a year. And that in 1974 to 1976 it averaged \$75 billion a year for a total of \$225 billion.

Now, what do you foresee as a comparable figure for say the next 3-year period?

Mr. SOLOMON. As I indicated, Senator, we would hope to see some modest reduction in the deficit over the next 3 years but not of an order of magnitude that is very significant. It is quite small.

Senator SARBANES. So we really would anticipate figures comparable to the \$225 billion total for 3-year period?

Mr. SOLOMON. Or close to that.

CURRENT ACCOUNTS DEFICITS

Senator SARBANES. In your statement you indicate the \$225 billion current account deficits for the periods of 1974 through 1976, and that figure of course contrasts with a \$45 billion figure for the previous 3-year period, so it is a fivefold increase in current account deficit. You indicated how that was financed for the 1974-76 period which was about 7 percent through the IMF, 18 percent through other official sources, investment lending by the regional banks and the balance, the remaining \$170 billion, through the private market, that is 75 percent, the \$225 billion.

Now, taking the statement you just made that the figure would be roughly the same current account deficit over the next 3-year period as the \$225 billion—it is not relevant for my purposes to argue about whether it be exactly the same, a little less or a little more, I just work with that figure. How will that be allocated in terms of financing as you foresee the current accounts deficit?

Mr. SOLOMON. Well, we might see as much as that 7 percent of the total being financed by the Fund. It might go to as much as 10 or even 11 percent. That would be the maximum and you have to make assumptions on what the level of official financing will be, investment lending by industrial countries, by OPEC, with the international institutions.

If one makes the assumption—and I don't know what is a better assumption to make—that the present level in real terms as a percentage of donor GNP continues, present level of GNP donor contribution share of their GNP in real terms, and if you further assume that stays the same over the next 3 years, then you would get a financing of something close to or in the neighborhood of \$55 billion to \$60 billion. Or maybe a little higher, \$60 billion to \$65 billion, in that neighborhood, in the next 3 years. I think it is \$55 billion. More in that neighborhood.

This is official lending to the developing countries and it includes both industrialized, bilateral AID programs, OPEC bilateral aid programs, and all the international institutions.

Senator SARBANES. So you have those first two categories then—under your projections move from say 25 percent of financing the total to 35 percent roughly?

Mr. SOLOMON. At a maximum.

Senator SARBANES. Which still leaves the commercial banks financing 65 to 70 percent of this enormous jump in the current accounts deficit, is that correct?

Mr. SOLOMON. Right. These are all best guesses on our part.

Senator CHURCH. May I ask a question here.

More and more of the investment from the OPEC countries as the first chart we looked at shows, is going into the government bonds, bills, and so forth. That is less than what is being deposited in the commercial banks?

USE OF PRIVATE CAPITAL MARKETS

Mr. SOLOMON. When we use the word "bank," I really meant private capital markets which is larger than banks. It also includes security issues and there is no question about the money being there. It is an arithmetical automatic process.

Senator SARBANES. Using your categories on page 3 and that encompasses banks and securities markets, I am trying to follow on through the categories you set out and get some projections as well as the report on the 1974 to 1976 period.

Mr. SOLOMON. I agree with your conclusion that 65 to 75 percent would still have to be financed by private capital markets. I think the funds will be there, though, Mr. Chairman.

Senator CHURCH. You have higher commercial activity in expanding economy, higher demand from corporate activity within the United States, more OPEC money going into the Government's securities than in the private sector. Is there no problem? Is the money supply endless?

Mr. SOLOMON. No; but the current account deficit is the exact mirror image of the advocate current account surplus in the world.

Senator CHURCH. But if the surplus is being invested more heavily in Government securities, and not in the private sector, does that matter?

Mr. SOLOMON. As the previous speaker indicated or even if he did not, the volume of OPEC purchase of U.S. securities is running around \$2½ billion a year so you are talking about a relatively small amount.

THE COMPOSITION OF FINANCING THE DEFICIT

Senator SARBANES. This statement, that the current account surplus and current account deficit are just the opposite side of the same coin, is true up to a point. The composition of the financing of the deficit, how that is done and by whom and on what terms, seems to me extremely important in terms of the problems you confront.

The first two categories of financing, the IMF and official financing, is not premised necessarily on commercial terms in terms of repayment of those. Those are systems which, in fact, are structured to take into account the necessity of providing financial aid in one form or another, isn't that correct?

Mr. SOLOMON. They are based on your own criteria as to which countries qualify drawing or for project loans, in the case of the World Bank and the availability of their resources.

Senator SARBANES. They come along and they make loans to, in effect, prevent a country from going under in which the third category, the private market would not make those loans according to its terms. Isn't that correct?

Mr. SOLOMON. If the country has waited to the very last minute to go into the Fund, you are right. Sometimes countries come in earlier when they still could borrow in private markets but they recognize themselves they should do a stabilization program.

THE TERMS OF THE PRIVATE MARKET

Senator SARBANES. The terms of the private market which is your third category, which is the one that is the prime financing mechanism, essentially depends on the statement on page 6 of your statement. You say in the middle paragraph:

Concern has been expressed that continued borrowing in very large amounts irrespective of who is borrowing or how the credit is used, constitutes a serious danger for the monetary system.

I do not share that view. "If"—underlined, and I agree with the underlining—"If the borrowed funds are properly used to support productive investment". And then at the end you again conclude the paragraph "but the borrowed funds should be productively invested in order to avoid servicing problems in the future".

ARE THE BORROWED FUNDS BEING PRODUCTIVELY INVESTED?

Now, are the borrowed funds being productively invested and are they being more productively invested today in terms of how they are being used than say they were being invested in the fifties and sixties? That may run back to the answer Mr. Sherman gave with respect to the U.S. investment, but I think it would apply more generally to the financing that is going on. What is the answer to that question?

Mr. SOLOMON. It varies from country to country depending on individual circumstances but what you might say is a reasonable typical fund stabilization agreement, a ceiling is placed on public sector expenditures as distinct from public sector capital investment. This means less money—

Senator SARBANES. You are talking about IMF now. I want to get away from that.

Mr. SOLOMON. I am talking about the fact that the whole thrust of the program is to make the investment more productive, you see. And it does that in various ways. I was going to list some of the specifics.

Senator SARBANES. No. I am not addressing either the IMF quota or the Witteveen facility or the second category, the direct official lending through one institution or another. I am not addressing the third category, the private markets. I am not really arguing about the Witteveen facility. I am beyond that to a somewhat broader problem and it is the private markets that carried 75 percent of this financing in the 1974 to 1976 period which you project would carry 65 to 70 percent in the next 3-year period and they are doing it on a quite different basis. They have got to depend—if those make sense—on the borrowed funds being productively invested in order to avoid servicing problems in the future.

Mr. SOLOMON. I think, Senator, that the history in this is mixed and is spotty. Some private lenders will be extremely careful, depending on

the country, that their loans are being used for productive investment, for specific projects. Other private lenders or the same private lenders—in the case of the countries where they feel that country is just barely creditworthy—may extend a general loan without inquiring into how the proceeds will be used.

I can't give you assurance concerning their information except possibly the fact that people are much more alert to the problems than they were. But I can't speak for the private bankers, that they will be more careful in the future that any loans that they make will go for productive investments.

THE BANKS REALLY DON'T HAVE TO EXERCISE MUCH CARE

Senator SARBANES. You think the private lenders have to a considerable extent been proceeding on the premise when they make loans to sovereign governments, that there is no possibility of default in those loans, first, because the sovereign government won't want it to happen. But in any event even if they were not able to carry the burden, that is the sovereign governments, particularly with respect to American banks, the United States is not going to permit that to take place. Therefore they really don't have to exercise much care with respect to making those loans?

Mr. SOLOMON. Well, I think that is a fairly strong statement, Senator. I know that the banks are concerned when they feel their money is being misused and the debt servicing capacity of the country borrowing is not keeping up with that. They get increasingly concerned and I have never heard them talk in those terms. Frequently what they will do is they will say themselves to a country, that here are the conditions under which we will lend and you have to follow on more sensible policies and they try and work it out.

If they cannot, their typical recourse is to say, well then you really ought to go to the Fund because we don't have the ability to help you work out that kind of an effective stabilization program.

Senator SARBANES. Yes, but when they go to the Fund and they come to the governments and say, you have to support the proposals to make it possible for the Fund to do this and that, when the countries to some extent have gotten into the situation in which they find themselves because the private lenders have been willing to extend this credit and build up a problem over a period of time.

THE AMERICAN EXPRESS STUDY

Senator CHURCH. Let me interject here one thing. I refer to an American Express study because that is the only one we can talk about. That study has to do with commercial loans, the very thing you are emphasizing. My understanding of the conclusions of the study is that by their analysis one-fifth of the repayments being made on commercial loans by these foreign governments in 1976 went to debt servicing, debt repayment. New loans went to the repayment of old loans.

In 1977, they estimated one-fourth of new loan money will go to repayment of old loans and by 1981, half. It seems to me the economics we are talking about here theoretically are very sound but they are not related to what is happening.

What is happening is that this new loan money is not going into the expansion of economic growth, increased exports, to enable these foreign countries to pay for their imports without having to borrow still more heavily. Just the opposite is happening.

Mr. SOLOMON. Mr. Chairman, in addition to those figures, you have to look at the increasing foreign exchange earnings of that country and its ability to service this debt.

Senator CHURCH. But if they are borrowing this heavily just to repay old loans how can they be investing in ways that expand their economies sufficiently to solve their problems? They are just borrowing their way deeper and deeper in debt.

THE CANADIAN SITUATION

Mr. SOLOMON. Canada has been doing it for 200 years. The volume of its external debt is mounting but the money is used productively. Its foreign exchange earnings increase, it can service its debt.

Senator CHURCH. Canada has a lot of fuel supplies and is not caught up on this oil paying. I can see Canada as a splendid example of a country that could work its way out of the world predicament but it is hardly typical. It is not the country with the problem.

Mr. SOLOMON. But this is a world of expanding trade, expanding GNP; hopefully it will continue that way.

One of the ways that works is on borrowed capital used productively.

THE PROBLEM OF THE SURPLUSES

Senator CHURCH. What you don't take into account here is that the whole problem arises from surplus. I am sorry for intervening on your time. The whole problem starts with this surplus which creates the disequilibrium which creates the deficit, the mirror image to which you referred.

Now, you can't through economic expansion achieve a new equilibrium unless the price of oil stays steady and that surplus is slowly absorbed and eliminated. Then you would have to do that, wouldn't you?

Mr. SOLOMON. I would agree completely that any increase in the price of oil is a drag.

THE STRANGLEHOLD OF OPEC

Senator CHURCH. It is more than just a drag if every time your whole plan to expand the economy of the United States and Germany and Japan increase, the level of imports to stimulate economic recovery in the Third World—all of this is on the theory that it reestablishes a new equilibrium again—but if the expansion that begins in the United States, Germany, and Japan and the Third World countries met with still another increase in the price of oil to preserve that \$40 billion annual surplus, you are never going to get there. Yet the Government of the United States will not confront the basic problem, the OPEC problem. Until you break the stranglehold that OPEC has on world oil prices you don't get there from here.

Mr. SOLOMON. I would certainly agree, Senator, that the OPEC problem is the key problem overwhelming the whole question of the pattern of imbalance. The magnitude could become enormous. I would agree this will be a very serious and permanent drag on recovery. It will be a causal kind of recycling problem but I don't know what to

do about it. The President has sent up an energy conservation program. Unless we can reduce the demands—it is incredible the hungry demands we have. Do you realize in the Japanese economy I understand they have not increased at all their oil import levels the last 3 years, yet they have had a reasonable growth rate. Other countries have been able to maintain increased growth but by a more efficient use of energy have not increased their imports of oil anywhere near in proportion to what we do. We seem to have no ability so far and unless the President's program succeeds I don't see any way we are going to solve the problem and in that, I would agree with you.

THE FUTILITY OF CONSERVATION

Senator CHURCH. I would take you one step further. Even if we have the kind of conservation program that currently the Japanese are managing, even if it were possible for Western Europe and the United States and the industrialized countries to conserve sufficiently on fuel, that their demand for imported fuel were to be held steady or even reduced, despite economic growth—that is a hard thing to pull off—suppose we were able to pull it off? It does not matter. You are not going to get your way out of this with conservation measures because you have in Saudi Arabia alone the capacity to cut back on production. The reduced demand will not cause OPEC to reduce prices but to increase them still higher to maintain their surplus.

Given the restraints the OPEC cartel has exercised on the price of fuel worldwide, the only way you can break that that I can see is through alternative sources of fuel that will break the grip that OPEC now has on the world oil price. I don't know any other solution and that is why I think all of our national policies should be directed toward stimulating those programs and providing those incentives that will have the effect of finding the alternative sources of supply. I don't think conservation will furnish you with an answer as long as OPEC can control the price regardless of volume. Regardless of reduced demands.

Mr. SOLOMON. You would agree that both sides of the coin are needed. Both conservation and new supplies?

Senator CHURCH. Conservation will be helpful, yes, because to the extent that we can conserve, the new supplies will not have to be so large to accomplish the result. In other words, to the extent we can conserve on the total fuel consumption we increase the possibility that we can find adequate alternative sources that will meet our needs. Only in that way do I see conservation actually helping.

Mr. SOLOMON. If we had been able to stabilize—this is a personal guess—if we had been able to stabilize, like the other key oil importing countries do, our level of oil imports 3 years ago when this started, within the first year after that, I would bet you today that the level of oil prices in the world today, notwithstanding the OPEC cartel, would be significantly lower. There would be so much slack on the supply of the supply-demand equation that there would be competitive bidding, competitive discounting, private discounting, and there would have been a very major difference in what kind of oil prices we are facing today. But the United States is the one that has put the additional burden on the world. You look at other people's oil import levels, you compare them with what is happening to ours. Ours is disgraceful, the way we jump up every year. I am sorry to get carried away and use strong terms but I don't see a solution without doing

something about our oil import bill and the solution involves working on many different funds, Senator.

Senator CHURCH. Conservation, as I have indicated is an essential part of the package but conservation alone won't solve the problem. You have to find some other sources for fuel besides the OPEC source on which we so heavily depend. We have to somehow break the grip that OPEC has over the world fuel prices.

Mr. SOLOMON. I am afraid I never got a chance to answer Senator Sarbanes.

Senator SARBANES. I have another committee meeting but go ahead.

Mr. SOLOMON. I have lost the track now a little of the very last question.

THE BALANCES

Senator SARBANES. Are you indifferent in your own view as to whether the current accounts surplus and deficit which obviously have to balance, balance at quite a low level relatively speaking. The \$15 billion average of 1971-73 are balanced off at \$75 or \$100 billion a year average. Does it matter as you perceive it?

Mr. SOLOMON. There is much more strain in the system to have the balance at that magnitude.

THE POLITICAL CONSEQUENCES

Senator SARBANES. It seems to me that the political consequences of the balancing off at the much higher levels are just enormous. I think at the lower levels you may be dealing with economic arrangements that are relatively value free at least to some extent. But when you start talking in the order of magnitude that we are dealing with now, you have an enormous political question in terms of the power that certain countries in effect hold because of their position. I think you have a very important question in this relationship between the private and the public sector. As for the public sector money, the IMF is going to set a time and they are going to check the country and they are going to impose conditions which, of course, carry with them political consequences. The country then is bound for that period of time but then it can turn right around to the private sector and put itself right back in the hole in the future, with the private sector responding on the assumption that the loans will be made good in any event because sovereign governments are not going to be permitted to default on their loans. You just keep a circle moving all the time.

Mr. SOLOMON. I would agree with what is basically the thrust of what you are saying, Senator, but I would also say in this man's world people have to bear their own responsibilities. There is no change, no mechanical change in the system which is going to stop irresponsible political leadership in a particular country from the minute it gets back into shape from going out and starting to borrow like mad.

Senator SARBANES. Let me turn it round the other way. Suppose you have a country in which we have very strong political interests and its political system is continuing to function as it is because it is, let's assume a democratic system and so forth and so on, and that the economic constraints placed upon it in order to obtain the international assistance are such that it may bring about political changes that we would regard as extremely undesirable. That is, turn it the other way. I am going both ways on you. But I think you should address both problems.

IS THE IMF TOUGH ENOUGH

Mr. SOLOMON. On that side of it, I must say that I find very little credibility in that argument. You could always conjecture you go this way, you have all kinds of problems. You go that way and you have all kinds of problems. The problems always contradict each other.

The complaint usually is that the IMF is not going to be tough enough to work out these programs, that the country will improve itself, you see, and therefore this debt situation is not improved and we don't get a more sustainable pattern or balance of payments deficit distribution.

Now, if you want to say on the other hand, oh, yes but then they will be too tough, therefore you can also conjecture up a scenario where governments fall and there is political repression and civil liberties get abused and I don't see that in the record. We can send the committee a history of, a listing of all the countries where the IMF has negotiated standby agreements over the last 10 or 20 or 30 years and we can see whether there seems to be some correlation. I have not observed it and I think that it becomes somewhat irresponsible for this kind of argument to be used that this will in some way violate human rights.

THE STAFF REPORT

Getting one's economic house in order is going to end up violating human rights. This is not what you said, Senator. You did not go this far but there was some implication of that in the staff report. I just don't see the validity for that kind of argument. If you have a moralistic exchange rate, you follow sounder fiscal monetary policies, sure you may not be helping your unemployment problems during the time being but if you take a look at Italy—look at the United Kingdom, look at Mexico and the last year they all felt that they have improved their economic performance substantially. Sure they have political problems with the high levels of unemployment. We do, too, in this country. And so does Germany, which has a high surplus and does not have to go to IMF, has a very high level of unemployment which is politically difficult for them and difficult in terms of human terms, compassionate terms but I feel it is a little far fetched to make that kind of argument.

THE UNITED KINGDOM/MEXICO EXAMPLES

Mr. LEVINSON. You keep using the examples of the United Kingdom, Mexico, and Italy. The United Kingdom and Mexico, as you know, have substantial oil finds. They have to hold the pound down because the North Sea oil is flowing in the way it is. You don't mention Jamaica or Peru where the finance ministers have an IMF agreement. You don't mention Turkey.

Mr. SOLOMON. Are you saying, Jerry, that in these cases the Fund is wrong? The Fund is asking for intensively hard conditions. Do you know the details of those three situations well enough to say that? You start off with the initial premise the Fund is wrong.

Mr. LEVINSON. I think we know the Jamaica situation well enough to know that contrary to what you said earlier that a good housekeeping seal of approval leads to an inflow of private lending, following upon IMF standby agreements. That has not occurred and Prime

Minister Manley has difficult problems at this point.

Mr. SOLOMON. He just concluded an agreement with the Fund. We have not had time to see how it will work.

What is your alternative? Should we just loan them money without conditionality?

Senator CHURCH. I think what Jerry is saying is that some of those countries may be in such rough shape that even the old tonic of the IMF, the old reliable medicine may not work anymore. And I think that there has not been time enough to know whether that is so in Jamaica. As you say, the IMF has just made its arrangement there. We see some serious danger signs that we ought not to overlook. The serious riots in Egypt for example certainly imperiled the Government. Maybe all these governments can survive, maybe some will fall. But these are symptoms that give us misgivings.

Peru is another hard case. That is not to say the IMF ought not to try and extend the loans with conditionality. But just because these remedies worked in a pre-OPEC period when we did not face a \$40 billion annual surplus that had to be somehow absorbed, and mounting deficits that are four and five times higher than the annual rate of the previous period, I don't think we can be altogether certain that the old methods will work under the new circumstances. I hope they do. You have done the best you can as far as Treasury goes. Treasury alone can't solve the OPEC problem. That is a matter of national policy and our national policy is filled with internal contradictions.

THE BREEDER REACTOR COULD SOLVE ENERGY PROBLEMS

You can't break the stranglehold of OPEC unless you find real alternatives to oil. Our nuclear policy contradicts that because the breeder reactor for example, is the one possibility in the nuclear field that would go far toward solving the energy problems of Western Europe, Japan, and other industrial nations. We are opposing that alternative. I don't hold Treasury accountable for this national policy. You are doing the best you can with what you have to work with but I don't think your argument is altogether persuasive that this new proposal will be an adequate tack. I hope it is, I think you have done a remarkably good job of negotiating. I commend you for bringing OPEC into the arrangement. I like this proposal a lot better than the previous administration's proposal in which the OPEC governments did not contribute anything.

As for the facility, I am prepared to support it and to say to you I think you have done a splendid job under difficult circumstances in negotiating it for the United States.

ADJUSTING THE WITTEVEEN FACILITY TO THE PROBLEMS

Mr. SOLOMON. First, I want to thank you for those words because life is tough enough as a government official without getting a word of praise every once in a while. You go out, you consult with Congress, you are trying to negotiate, you try and bring home the bacon as the expression goes, and then quite frequently everybody from the arena and from all sides on the question then begin nitpicking. But I think though, that I would like to make two points as to how we have

attempted to adjust the Witteveen Facility to the problems that you raised about the question of excessive austerity.

We have done two things. One, we have provided instead of a 1-year adjustment program that when a country has a difficult enough problem that it has to draw on the Witteveen Facility the adjustment period should be 2 and even 3 years which makes it an easier problem to get back.

Second, under the Witteveen Facility the maximum drawings that a country is able to make will not be rigidly limited by its quota. There are some countries that have unusually large problems in relation to the size of their quota. It is through the pace of the adjustment and the volume of transitional financial assistance that you give them that you can have a more cooperative effort to bring about a more sensible situation and take into consideration the political strains.

Now, I think we have faced up to this. This is not a traditional funds doctrine. This is significantly different in these two measures. The idea of having drawing not being rigidly related to quota or extending the period of adjustment beyond what was traditional does represent I think significant improvements and to some degrees our attempt to recognize the kinds of problem which if it has been put forth in more moderate language I would have heartily agreed with. The only thing I take some umbrage at is the argument that this all leads to flagrant violation of human rights which I think is really far fetched. That is all I had to say, Mr. Chairman.

Mr. LEVINSON. That is a detail.

Mr. SOLOMON. In the staff report it said this would lead to violation of human rights.

Mr. LEVINSON. It said conceivably.

Mr. SOLOMON. Conceivably, right.

Senator CHURCH. Conceivably.

Mr. LEVINSON. Conceivably it could.

AUSTERITY MEASURES

Senator CHURCH. Austerity measures may lead to repressive government. That is not an illogical link but we are not blaming you for that and I think you are making every effort to avoid that in the way you handle your work.

Now, if we are friends again, let's go back to the chart. Look at how much of the surplus since 1974 is being invested in the developed countries. Practically all of it. The blue represents the developing countries. Seven percent in 1974, running at about 15 percent now. The balance is all coming into the developed countries and the larger part of it coming to the United States all the time. Why is this in petrodollars advantageous to the United States?

Mr. SOLOMON. Why is the inflow of dollars?

WHAT ARE THE ADVANTAGES TO THE U.S.?

Senator CHURCH. Why wouldn't it be better for the United States if the surplus were being extended directly to underdeveloped coun-

tries to help them pay their oil bills rather than being diverted through the United States so we end up holding the bag?

Mr. SOLOMON. Well, I think that it would be preferable if a much greater proportion of OPEC investable surplus was going directly to the developing countries. They have been increasing the rate at which they disburse. They are running this year at the rate of \$8 billion. These are mostly concessional features. They are forms of aid really primarily. They take the position that in most cases they are basically underdeveloped, unindustrialized poor countries who have a great pool of surplus wealth available to them for the next 10 to 30 years depending on the country you are talking to.

In most cases they are not counting a small country like Kuwait, but in most cases their per capita income is much lower than that of the industrialized countries, that they are not the true solid, stable wealth of the world. In fact, some of them will talk simply in terms of, we are awash with liquidity and we don't have any real wealth behind all this paper.

Now, that is their point of view. Our point of view is that we would like to see them use these large surpluses to the maximum extent possible for contributions to international institutions, for their own bilateral aid programs, et cetera. I guess all I can say is that I agree with the Senator in the sense that I think it would be desirable.

On the other hand, the fact that it comes here like a lot of other capital comes here, is not unique of the OPEC countries. We have approximately today \$92 billion of our Treasury securities and instrument of various kinds are held by for even official institutions, \$92. And of that approximately \$12 billion are held by OPEC banks. This is the largest capital market. We have a free and open capital market. There is a lot of European money that comes here as well, private European funds. We have the political stability. We have the ability to absorb large amounts of capital and the OPEC countries like other countries, respond to that situation.

THE ANOMALY OF THE SITUATION

Senator CHURCH. Does that lead to this anomaly that we heard in the earlier testimony that we are able to borrow from the OPEC countries; that is, our own Treasury is able to borrow from OPEC countries at 5 or 6 percent but the poorer countries that are borrowing mainly from the commercial banks are paying 8 to 9 percent interest.

So we have the United States, which as you say, has a very strong economy borrowing at 5 or 6 percent up to 7 maybe, in some cases, from these OPEC governments. But in order to pay their oil bills the poorer countries rely mainly on the commercial banks here in the United States for their credit and are paying 9 percent?

Mr. SOLOMON. That is true in capital markets all over. That is not just where OPEC lends. They just follow the capital market yield and this is a fact of life. Of course, the poor countries go to private capital markets, are bigger risks and pay higher rates in those markets.

Mr. Widman has pointed out to me that I should point out in addition to what I just said the very poorest of the LDC's are not going to the capital markets.

Senator CHURCH. They can't afford it.

Mr. SOLOMON. Right, they don't have access and they are getting the advantage of the rates that are set by the international institutions and the bilateral aid program.

Senator CHURCH. Have you any further questions?

Mr. LEVINSON. Just to clean up the record and as quickly as I can.

THE OVERALLOTMENT PROCEDURE

When you said earlier that there are no preferential arrangements, never have been, for attracting OPEC funds, Mr. Sherman described the overallotment procedure. Wasn't that set up in 1974 explicitly to attract Saudi funds?

Mr. SOLOMON. I am sorry if I said there never was one. It was set up for Saudi Arabia but then was quickly extended to all foreign governments and today you have a much larger volume of purchases coming in from industrialized countries, central banks than you do from OPEC central banks and we do not consider it significantly preferential in a certain sense.

My people argue with me that it is not preferential at all because we find that foreign governments' central banks sometimes buy through the dealers where they want to bid and we don't permit them to bid when it comes to what we call these foreign add-ons. The reason why it was in the U.S. interest to have this alternative route, supplementary route is that we did not want to disrupt the markets which handle our debt management by having excessive amounts of large money suddenly surging in from foreign countries and we have certain internal guidelines on how much we will permit. We do not permit all the foreign countries that wish to buy when the amounts are excessive in relation to any issue. We keep this under control.

Now, we make no effort to attract this money. This money just comes in. It is one of the various forms of Treasury borrowing. After all, the Treasury borrows approximately \$400 billion a year gross and it is still a relatively small item in our overall picture.

Mr. LEVINSON. So looking at the line, the gray fluted line, you have no explanation for why late 1976 on into 1977 received—this relatively flat line turning upward—fairly dramatic terms since the last quarter of 1976 and on into 1977?

Mr. SOLOMON. My assumption is that they felt sufficiently un-nervous so that they shifted from holding so much in bank deposits to wanting to go into longer term securities.

Now, these longer term securities are not terribly long. Foreign governments generally, including the OPEC governments, tend to purchase primarily in the 2- to 5-year range, sometimes up to 7 or 10 years but the bulk of it is in the 2- to 5-note range. I guess they felt since there is a slight interest differential as between investing in 6 months bills or 6 months CD's and going into somewhat longer maturity, it made financial sense for them.

Mr. LEVINSON. Would you say there is some political judgment involved on their part that they are willing to tie up fairly significant sums in longer term securities, that is to say, about the political stability. I don't want to press that.

Mr. SOLOMON. You mean about the political stability of this country.

Mr. LEVINSON. No, the Middle East political situation. Their political judgment in that.

Mr. SOLOMON. I don't have any reason to assume that. One of the problems is when you get very rich, as rich as they are, you know you have to look around for places to put your money. And it seems to me that the capital markets in Germany and Switzerland are pretty small. This is the big capital market. They can place larger sums here. If they are going to have larger sums here they might as well have a healthy hunk of it in 2- to 5-year money rather than in 6-month bills.

TREASURY BULLETIN FIGURES

Mr. LEVINSON. The last two factual clarifications are simply that the Treasury Bulletin of August 1977 and Treasury international capital movements reports do show that of the banking and portfolio placements by type in the United States by Middle East oil exporters 25 percent is in short-term placements and I think in your testimony you indicated a figure of 3 percent.

Mr. SOLOMON. But the figure here—I am talking about—

Mr. LEVINSON. Is there any way that can be corrected for the record? I just wanted to point that out.

Mr. SOLOMON. It is only \$287 million if I remember correctly in less than 1-year instruments.

Mr. LEVINSON. Maybe it is a question of what is considered short-term placements, the definition of that. We can clean that up for the record.

Mr. SOLOMON. We have \$287 million in 1975. Short-term placements \$246 million in 1976.

Mr. LEVINSON. Why don't we clean that up rather than pursue it?

THE LARGEST TRADE DEFICIT WE EVER HAD

Senator CHURCH. Just one final observation for your comment and we will wrap up the hearing this morning. In 1974, as I recall, this country had a trade surplus of \$9 billion. Now, barely 4 years later, we have a trade deficit of what—\$25 billion?

Mr. SOLOMON. \$25 billion or more.

Senator CHURCH. Isn't that as large a trade deficit as we ever had?

Mr. SOLOMON. That is true.

Senator CHURCH. Four years ago we were paying between \$7 billion and \$8 billion for our oil imports. How much will we be paying this year?

Mr. SOLOMON. Forty-five.

Senator CHURCH. And what will be the deficit in our balance of payments this year?

Mr. SOLOMON. Current account deficit?

Senator CHURCH. Current account deficit.

Mr. SOLOMON. It will probably be in the neighborhood of \$16 billion to \$18 billion.

Senator CHURCH. How does that compare with the past?

Mr. SOLOMON. That is also higher. You see, we used to have a liquidity overall balance of payments deficit, which is very different than the present, but I think this is a higher current account.

Senator CHURCH. So we have the highest deficit in our current account, the highest trade deficit in our history. We are extending the credit or a large part of the credit to enable the less-developed countries to pay for their imports and to meet the higher cost of fuel. The end result is that we are in a very heavy deficit position.

OTHER STRONG ECONOMIES IN THE WORLD

Now, there are some other strong economies in the world—the Germans, the Japanese. Are they in a comparable deficit position?

Mr. SOLOMON. No, Mr. Chairman. They are returning surplus.

Senator CHURCH. It seems to me they are managing their affairs a lot better than we are. The contrast is vivid, isn't it? Is this simply because they have opted out?

Mr. SOLOMON. It is primarily due to two factors, sir. One is that they kept their energy oil import bill much more under control than we have. And, second, we are running a much higher rate of real growth than Germany. Traditionally in this country the import elasticity of income to the United States has doubled that of what it is in Europe.

Therefore, this was balanced off in the past by the fact that in the sixties the Europeans ran a higher real growth rate; so that, even though we had a higher import elasticity of income, as our growth rate increased it was altered by the fact we were offering a lower import elasticity, so the two tended to balance out somewhat more than they do now.

Now you have the curious situation where the United States is running a higher real growth rate than Western Europe by far and, on top of that, we have the higher import elasticity.

Now, if you look at the shift in the trade deficit between last year, 1976, and 1977, what you see is that roughly close to half is due to the increase in oil imports and the other half is primarily due to increased imports both from LDC's and from some of the industrialized countries.

On the export side there has been some reduction in import demand from the United States from countries like Mexico and Brazil who have been going through destabilization programs, so the prospect looks slightly better for next year in terms of levels of import demand from those areas because they have gone through the worst of it.

THE OVERALL PICTURE

On the other hand, the overall picture is not a good one and the energy bill keeps increasing and it keeps increasing at the rate of \$4, \$4.5, \$5 billion a year and, unless we face up to the central problem, I don't see that there is any solution.

Senator CHURCH. With that I agree, and that is the place to stop the hearing this morning. Thank you very much.

[Whereupon, at 12:50 p.m. the subcommittee adjourned.]

THE WITTEVEEN FACILITY AND THE OPEC FINANCIAL SURPLUSES

FRIDAY, SEPTEMBER 23, 1977

UNITED STATES SENATE,
SUBCOMMITTEE ON FOREIGN ECONOMIC POLICY
OF THE COMMITTEE ON FOREIGN RELATIONS,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:07 a.m., in room 4221, Dirksen Senate Office Building, Hon. Frank Church, chairman, presiding.

Present: Senators Church, Sparkman, Clark, Sarbanes, and Javits.
Also present: Jerome Levinson, chief counsel.

Senator CHURCH. The subcommittee will please come to order.

Our first witness this morning is Albert Fishlow of the Department of Economics, University of California at Berkeley.

Professor Fishlow, would you please proceed.

STATEMENT OF ALBERT FISHLOW, DEPARTMENT OF ECONOMICS, UNIVERSITY OF CALIFORNIA, BERKELEY, CALIF.

Mr. FISHLOW. Thank you, Mr. Chairman.

I have a prepared statement, but I will not take your time by reading it all. Rather, in brief preliminary remarks, I would like to highlight what I think are part of the important aspects of the debt problem with which the subcommittee is concerned this morning.¹

In the first instance, it seems to me important to define the magnitude of the problem. There are divergent opinions on this subject, in part because there are so many sets of divergent numbers that have been divulged. Some of the numbers refer to disbursed debts, some refer to outstanding debt, some of gross of reserves of the developing countries, others subtract those particular reserves.

I think these provide very different pictures, depending upon which are chosen.

I think a fair estimate suggests that the official debt figures which are widely promulgated by the World Bank understate the magnitude of the problem. That is because they exclude those debts which are not guaranteed by public entities, and to that extent fall short. Thus, for example, the World Bank reporting statistics suggest that at the end of 1976 there was something like \$110 billion of debt outstanding to developing countries, excluding those of the Mediterranean area, whereas I think a more reasonable estimate would add at least another \$50 billion to that, largely, indeed almost exclusively, commercial bank

¹ See p. 162 for Mr. Fishlow's prepared statement.

credits, many of them short-term, in order to finance the balance of payments.

On the other side, however, it is important to take into account the fact that there are offsetting reserves and that these reserves for many countries have grown in recent years.

The problem of the debt has come into prominence, in part, because of the deposits from the OPEC countries. The unprecedented surpluses that were accumulated as a consequence of the rise of petroleum prices accelerated a process that was already in motion before. That is a point that I would like to emphasize.

Even before the concentration of OPEC surpluses beginning in 1974, in the Eurocurrency market there was already a sharp increase in the amount of lending that was being done from the Eurocurrency market to developing countries. That lending, in part, was responsive to the fact that the middle income developing countries were showing acceleration in their growth rates as well as increased integration into world markets.

The OPEC surpluses in 1974, in particular, being held in short-term fashion, accelerated that change. I would like to emphasize, however, that by 1976 the OPEC deposits represented a very small part of the total resources that are, in fact, being channeled now to developing countries. Those deposits, in fact, are a minority of the total credits that have been made available to the developing countries. A larger share comes from deposits in the countries of Western Europe and the United States and from the developing countries themselves. It is well to point out that last year something on the order of \$10 to \$12 billion of deposits emanated from the developing countries themselves, which is the counterpart to the increase in reserves that were accumulated in 1976.

OPEC SURPLUS

Senator CHURCH. Professor, when you speak of the OPEC surplus that is going to the underdeveloped countries, you are speaking of direct loans or investments by OPEC in those countries, are you not?

Mr. FISHLOW. No. What I am trying to emphasize precisely is the fact that the OPEC deposits in the Eurocurrency market have gone down rather considerably since 1974. The actual allocation of OPEC funds, according to the Bank for International Settlements, according to its last report, is that only something on the order of \$12 billion of the OPEC total surplus of something about more than \$35 billion actually found its way into Eurocurrency deposits.

WHERE DID THE REST OF IT GO?

Mr. LEVINSON. The rest of it went where?

Mr. FISHLOW. The rest of it went in part to direct assistance, largely within the Arab bloc of countries, in terms of aid to developing countries. Another part of it was placed in bonds through the Euromarket, but do not constitute actual currency deposits with banks in the Eurocurrency market.

Mr. LEVINSON. The significance of this, then, is how much is available for relending to developing countries, is it not?

Mr. FISHLOW. I suppose the point I am trying to make, if you like, is while the OPEC surpluses have been highlighted in the context of the question of debt, it is very important to appreciate that the Eurocurrency market is, in fact, being nourished at the moment by the deposits coming from the industrialized countries. Those deposits are coming from the industrialized countries and being relent to developing countries precisely because of the lack of demand within the industrialized countries.

The consequence of the recession and the slowdown of activity in the industrialized countries has meant that it is now private money from those countries which is flowing out through the Eurocurrency market to developing countries.

Senator CHURCH. Well, our figures show that of OPEC's investable surplus in 1974, a large part of it—\$22.5 billion—was invested in the Euromarket. That has been coming down. For example, in 1976, it was \$11 billion.

Mr. FISHLOW. The 1976 figure is what I was referring to, and the sharp reduction from the \$20 billion in 1974 is noteworthy.

INVESTMENT IN THE UNITED STATES BY OPEC

Senator CHURCH. On the other hand, the investment in the United States by the OPEC countries of the surplus has been going up.

Is that not so? Are we in agreement?

Mr. FISHLOW. I think we are in agreement on those figures. The inference I draw from it, however, is that the problem of international financial markets goes beyond the question of the OPEC surpluses per se; that while in the balance-of-payments sense they obviously provide the balance-of-payments deficits that set up the demand for these loans, on the other hand, the nature of the market has to be understood in a broader context rather than by focusing solely on the OPEC surplus. This is the reason I wanted to emphasize that particular point.

Now, in terms of the magnitude of the problem, I had been asked to emphasize to some degree the case of Latin America. I think it is appropriate to focus on the case of the Western Hemisphere.

LATIN AMERICA

It is clear that Brazil and Mexico together account for the great preponderance of all commercial bank loans to developing countries. On a net basis, the Western Hemisphere is probably the only region with a significant net imbalance, that is to say, one in which the loans from the international banks significantly exceed the offsetting deposits.

For Latin America as a whole, the three countries—Brazil, Mexico, and Peru—come up to something of the order of three-fourths of the total net debt. This is for Latin America as a whole, once one takes out the reserve accumulations in these particular countries.

THE BANK DEBT

The bank debt, as a proportion of the total in Latin America, is itself very high. One would find that it ranges from a minimum of somewhere more than half to more likely a figure that is closer to

60 percent. So, it is in Latin America, if you like, that much of the debt problem occurs. It is also obvious that in Latin America, both because of its proximity and much closer economic ties to the United States, the foreign policy repercussions of the debt problem and the way in which one adapts to it are greatest.

Senator CHURCH. Let me ask you another question.

At our opening hearing we learned that there is a very pronounced increase in the amount of OPEC surplus money that is being invested in Treasury notes and bills.

NATURE OF INVESTMENT IN THE UNITED STATES

Now I suppose that is part of the trend away from the Euromarket and toward the United States. But the nature of the investment in the United States is much more heavily weighted now in favor of Treasury notes and bills than it used to be. Does this mean that OPEC is even more removed from the risks involved in lending to deficit countries than was previously the case?

Mr. FISHLOW. Well, to the extent that the credit of the U.S. Government represents a more substantial credit than that of the large international banks, that is, of course, true. I think that the short-term nature of the liabilities that the banks had to the OPEC countries, on the other hand, made them very safe investments as well.

So I think it is really more a question of diversification from their point of view rather than a significant change in the risk.

Senator CHURCH. Thank you. But diversification is usually practiced in order to minimize risks, isn't it?

Mr. FISHLOW. I think that prudent management of such large resources would suggest that they don't want to hold them all in the banks.

Senator CHURCH. The reason for that is that they want to reduce the risks as much as possible, isn't it?

Mr. FISHLOW. Yes. I think that is fair.

THE LATIN AMERICAN SITUATION

As far as the Latin American situation is concerned, the magnitude of the debt, as I was suggesting, in Latin America and its principal countries constitutes most of the important cases, if you like, that exist. They also represent very different variants, and I think it is worth just spending a minute indicating how some of these countries got into debt. I think the way in which they did was very different in all three cases. I think we need to get some idea of the diversity of the experience that is involved.

In the case of Brazil, I think the accumulation of debt was a natural extension of the pre-OPEC situation; that is to say, Brazil was already receiving large quantities of resources in the period of the early 1970's, largely as a consequence of rapid growth of exports. Brazil was a very attractive market, and, as I think is well known, the very low rates of return in the industrialized countries in 1971 and early 1972 resulted in a very substantial outflow and Brazil was one of the favored countries. Indeed, Brazil was so favored that it had to

adopt a series of regulations in order to restrict the inflow of resources and to keep the banks from putting in more than Brazil felt prudent.

Even so, Brazil, in fact, had to sterilize a large part of the foreign resources it received at that time in order to prevent it from creating domestic inflation and the reserves were of very little use to it.

The case of Peru, on the other hand, is a very different circumstance.

The Peruvian debt managed to rise extraordinarily rapidly as a consequence of the doubling of export prices in 1973-74 in the midst of the commodity boom. It was the extraordinarily high prices for copper and for fishmeal and the booming state of Peruvian exports that led to a very substantial inflow of debt at that particular time.

THE INFLOW OF PRIVATE DEBT IN LATIN AMERICA

Mr. LEVINSON. You mean private, don't you? You are talking at this time primarily about the inflow of private debt.

Mr. FISHLOW. Yes.

I think the important point to make in the case of all of these Latin American countries is that we are talking about proportions of private debt that are very, very high. If we take into account the total debt and not merely the external public debt, we are talking about proportions of debt that are somewhere in the neighborhood of 75 percent or so.

Those data up there [indicating] tend to understate the participation of the private sector because they refer only to the external public debt. In the case of Latin America, something on the order of \$25 billion already has been disbursed of nonguaranteed debt, almost all of it from the commercial banks and exclusively from the private sector. So we are talking about a very considerable inflow. The official sources in Latin America have not played a very significant role in recent years.

In the Peruvian case, then, one had a response to very much more of a temporary favorable development in international trade. Peru responded to the availability of foreign exchange by increasing its imports extraordinarily rapidly.

The OPEC crisis and the rise in oil prices was not the cause of the Peruvian debt situation in the same way that it contributed to the Brazilian, where the Brazilian attempt to sustain very high rates of growth after 1974 successfully meant unprecedented inflows of foreign capital.

THE CASE OF MEXICO

The final case that is worth noting is the case of Mexico, which had for a long time enjoyed a very high rate of growth and was one of the most stable among the developing countries.

There the accumulation of debt in recent years was very much more in response to domestic circumstances and to the disequilibria within the Mexican economy which accumulating debt was designed to patch over. In fact, all that it led to was an overvaluation of the peso and ultimately capital flight meant devaluation was necessary.

In all of these cases, then, one has very different scenarios that are associated with the nature of the debt problem. It is for that

reason that they also have very different perspectives, it seems to me, in terms of the future.

I think it is realistic when one puts together, as I have elsewhere, intermediate term projections for Mexican debt and evolution of Mexican gross product—exports and imports—that the long-term perspectives for Mexico are rather optimistic. The reason for that is very simply the abundance of petroleum and the likelihood that PEMEX will be able to develop that petroleum.

This means, in fact, that it is possible for Mexico, even with modest rates of growth of exports that seem quite reasonable, to reduce its current service ratio on the foreign debt over the next 10 years and still to grow fairly rapidly.

THE PERUVIAN DEBT

The case of Peru, on the other hand, is probably the polar extreme on the other side. Peru has gotten into debt that involves service payments now on an order of magnitude of about 45 percent of total exports. Those kinds of obligations can only be canceled out by very high rates of growth of exports.

ECONOMIC THEORIES

Senator CHURCH. Let me make an inquiry at this point.

I think we on this committee are very familiar with economic theories. Rapid internal development producing larger quantities of exports will naturally enable a country to handle its external debt, reduce it, and thus to pull itself up by its own bootstraps and work its way out of the hole.

But when you have a country having to borrow additional money, 45 percent of which has to be used just to pay the interest and rollover old debt, how does it achieve this internal growth sufficiently to handle its financial problems?

Mr. FISHLOW. I was not trying to gloss over that problem, Senator, but indeed was trying to emphasize that very difficulty.

It seems to me that analyzing the question as if the internal development would automatically produce the exports is the wrong way of looking at the matter.

The case of Mexico is different precisely because they have a bonanza.

Senator CHURCH. Yes.

Mr. FISHLOW. In the case of Peru, that bonanza is not at all obvious or evident.

Indeed, as I suggest in my prepared statement, I regard Peru as precisely the kind of case which is a debt trap in which the increasing quantities of debt merely go to pay off the former debt without being able to work itself out of the particular hole.

THE AMERICAN EXPRESS STUDY

Senator CHURCH. Have you looked at the study that came to the attention of this subcommittee? It was done by American Express. Have you had a chance to examine that study? It is a study of the

debt service, the mounting debt service problem as it affects commercial banks.

I don't know whether or not the study is accurate, but it is very alarming. If indeed it is accurate, it should give us all considerable pause. We should stop, look, and listen if this study is right.

As I understand the conclusions of the study, it is to the effect that last year—that is, 1976—approximately one-fifth of all of the new borrowing by the underdeveloped countries went to debt service; and, in 1977, the study estimates that approximately one-fourth of all the new borrowing will go to debt service. It says that by 1980, approximately one-half of all the new borrowing will go to debt service.

Now if that is the way we are moving, somewhere down that road lies a bankruptcy and a repudiation of the debt, with all of the calamitous consequences that would have on the credit structure, the banking structure, and the financial structure of the Western World.

Mr. FISHLOW. While I have not seen the study, I believe I agree that the direction that is pointed to by that study is perfectly correct. The very essence of the problem of debt finance is that it takes ever larger quantities of debts in order to transfer the same amount of resources, because you have an offsetting flow that, in fact, comes back all the time.

This, of course, is the classic reason why in order to finance the development of countries in any significant fashion, one needs very much larger and continuing increasing inflows of gross resources for a constant amount of net resource transfer.

I think what averts, however, the necessity for bankruptcy at the end of that particular line is simply the fact that the counterpart over time of successful debt-led development is a rapid increase in exports and foreign exchange earnings. This makes it possible for countries to manage to repay it.

It seems to me that that is precisely the point I would underline as being of the essence in this particular discussion.

THE DEBT QUESTION

The debt question is on the other side a trade question. To focus exclusively on the debt problem and to look at the financial magnitudes without concerning oneself with the real magnitudes is to see the problem in only a partial aspect.

Particularly for the developing countries, given the fact of continuing surpluses for the OPEC countries, one is faced with one or two choices. Either those deficits get transferred around so that the industrialized countries import substantially more and therefore are in a position of receiving the exports and repaying the past debt of the developing countries, or, on the other side, it is necessary for continuing outflows of resources to go to the developing countries precisely to counteract these reflows. That is the essence of the problem.

Senator CHURCH. Yes. But when you suggest that the developed countries will be the marketplace for large quantities of exports from the underdeveloped world, I wonder whether the developed countries will be able to expand purchases sufficiently. When you consider that

our own balance of trade deficit is now the largest in our history—about \$25 billion—and our balance-of-payments deficit on current accounts is also the largest in our history, it is hard to see how we can afford to absorb larger and larger quantities of exports from the underdeveloped world.

Mr. FISHLOW. I think, Mr. Chairman, that explains one of the reasons why the United States is so eager for Japan and Germany to increase their rates of expansion and to absorb substantially more of these products.

Senator CHURCH. But Japan and Germany don't seem so eager to do it. Certainly it is not possible for three countries—the United States, Japan, and Germany—to do this job for the whole of the underdeveloped world, even if the German and Japanese Governments were more inclined to follow our lead. If they are not so inclined, that leaves the United States alone among the developed countries. Clearly the Third World cannot find all of its markets here.

Mr. FISHLOW. I think that is certainly the case. I think it is precisely that reality which underlies the seriousness of the particular problem.

I think it is well to appreciate that the financial side of the question may very well be less significant and only the symptom of precisely the problem of the real imbalance. The American Express findings in themselves are not frightening if one presumes that there is a continuing outflow of resources, a continuing lending of resources, which enable the surpluses and deficits all to balance out at relatively high rates of world growth.

THE TWO WORLDS OF FACTS AND THEORIES

Senator CHURCH. Have you examined the export trends? Do they substantiate the theory, or is this a case where the theory lives in one world and the facts in another?

To what degree are the export levels expanding? Are they expanding sufficiently to counterbalance rapid increases in debt?

Mr. FISHLOW. I think in the case of Mexico that the projections are clearly favorable. That, therefore, is one of the reasons why I differentiate that circumstance. Because of petroleum exports there is very likely to be that kind of working out of the debt model. Indeed, the Mexican case is precisely one in which insufficient availability of resources to develop the petroleum may handicap the situation.

Senator CHURCH. Right. You have mentioned Mexico as being a country which, because of its oil discoveries, may be able to handle its external debt. You have mentioned Peru as a case where debt may be outrunning the capacity of the country to pay.

CAN THIRD WORLD COUNTERBALANCE DEBTS?

Haven't any studies been done on the Third World generally to determine whether the growth is sufficient to counterbalance the rapidly mounting debts?

Mr. FISHLOW. I think studies have been done. One of the limitations, of course, is that by its very nature the debt problem is also a specific country problem and it is one which is very highly concentrated, as the chart up there suggests [indicating]. The nature of the private

debt, in particular, is extraordinarily concentrated and commercial bank debt is even more. Of the total of about \$89 billion, I guess, that the Bank of International Settlements identified at the end of 1976, Mexico and Brazil accounted for the lion's share. So, when we talk about the Third World problem and the debt problem in general, I think again that it is useful to descend back into those specifics.

Senator CHURCH. All right.

THE QUESTION OF BRAZIL

You have mentioned Peru and Mexico. Have you done a similar study on Brazil?

Mr. FISHLOW. Yes.

Brazil affords precisely the intermediate case because it is one in which in many respects the internal developments have proceeded very rapidly over the last decade and one in which the potential for export of a diversified kind exists. But ultimately, as I suggest, projections of that debt situation depend intimately upon projections of what the rate of growth of the industrialized economies are going to be, what the terms of trade in fact will be for primary commodities. Therefore one cannot isolate the debt problem from the whole range of development issues.

THE ECONOMIC GROWTH OF THE INDUSTRIAL WORLD

Senator CHURCH. Right now the economic growth rate of the industrial world is not such as to be much encouraging.

Mr. FISHLOW. No. I think precisely the projected turndowns in world trade are a cause for great concern. But again, I would stress that in many ways the accumulating debts in these particular countries was not merely in response to their own demands. They also had a favorable impact upon the developed countries. They helped, in fact, to speed the developed countries out of the world recession.

For every dollar that went out in debt to the developing countries, about \$1½ has been estimated to have come back in increased demand for exports from the industrialized countries. So one does have a very tightly connected system here between the nature of the debt and the industrialized countries in the real sense and not merely the financial. That, I think, is one of the fundamental points which has to be appreciated, in addition to—and I think you are quite rightly concerned with it—the vulnerability of the particular financial structure because of the extraordinary extent to which it has been privately financed, and the adjustment problems that are associated with it.

But I think that real counterpart is important as well.

I will turn, in fact, to some of these financial questions, if I may, briefly.

THE INTERRELATIONSHIPS OF THE WITTEVEEN FACILITY

Mr. LEVINSON. Would you also address two other issues in the course of your development of this interrelationship? That is, we have before this subcommittee the Witteveen Facility, which is premised upon the IMF imposing as a condition, conditionality, which translates into the

countries' accepting adjustment, which means certain policies which will restrict their imports and make them more export oriented. This, in turn, means that that market to which you have just referred, helped the industrialized world begin the process of getting out of the recession by exporting to developing countries, and the developing countries, as part of the adjustment, are going to cut back on their imports. This means there will be less exports to them from the industrialized countries. So, we are in a circle. Would you address that, please?

Would you also address the short-term Mexican situation? You alluded to this but did not develop it. Would you discuss whether PEMEX can develop the oil in time to get out of the increasing debt service?

Would you also address the bunching up of debt service in the next 3 years because of the structure of the debt that was incurred, pre-OPEC and post-OPEC?

Mr. FISHLOW. Yes; I will try to do that briefly as well.

Senator CHURCH. I hope your explanation is briefer than the question. [General laughter.]

Mr. LEVINSON. Senator, I am sure Mr. Fishlow knows what I mean. [General laughter.]

DEALING WITH THE PROBLEM

Mr. FISHLOW. The way of dealing with the problem, Mr. Chairman, as I think you have rightly pointed out, with the circumstances and prospects for exports being what they are, relying solely upon exports is certainly not going to be one of the ways out. Therefore a great deal of attention has turned to adjustment by the principal debtor countries in order to reduce their imports and engage in reduction of growth as a way of so doing.

Here, quite frankly, I do have to express some concern that if that adjustment is forced upon these countries in a fashion which is orthodox, conservative, and without full regard precisely for the repercussions upon the demand for the exports of the industrialized world, the nature of the adjustment process can have repercussions well beyond slowing down the rate of growth of some of the debtor's LDC's, and also slowing down world growth.

In the second instance I think it is fair to say that in many instances slowing down growth does not accomplish the internal transformations that one is seeking. The mere slowdown of rates of increase of inflation does not turn out, in fact, to be sufficient.

I think that the IMF has been cognizant of some of these changes. It used to be the case that the visit of an IMF mission to Latin America as well as to other parts of the world was sufficient to bring a government down. Now what it does is simply cause riots, as there is somewhat greater stability.

THE ADJUSTMENT PROCESSES

That more facetious comment aside, I think it is the case that the IMF has taken into account some of the longer run aspects of the adjustment process that the present unusual debt circumstances require.

The other side of this particular aspect is that if the adjustment process is to be prolonged and is not to occur immediately over time, there has to be available resources for these developing countries to continue to borrow. There cannot be, again, the best of all worlds which is an adjustment process which is gradual and which does not significantly impinge the imports of these countries, expands the exports of these countries, without at the same time resulting in increased debt to these countries.

The ultimate issue is whether the debt is going to be productive or nonproductive.

It seems to me that rather than focus on debt per se, it would be better to frame the issue as to whether the incremental debt is likely to be productive or nonproductive.

In the assessment of the adjustment process, that sort of issue has to be kept in the forefront.

DANGER OF EXPOSURE OF COMMERCIAL BANKS

The danger of having such a large exposure of private commercial banks precisely seems to me that, as institutions, they themselves are not equipped to deal with this particular problem. The time horizon of the private banks is, in fact, very short. The motivation of the private banks is, as for all private institutions, profit.

Those particular considerations make this kind of delicate adjustment process a much more difficult one.

I would also like to point out one aspect of the profitability situation of the private banks that is relevant. Without causing generalized bankruptcy or other great breakdowns in the international system, it is true that the commercial banks, exactly because of the higher risk premia that they have been charging to lenders in developing countries, are in a position to absorb more rescheduling, are in a position to extend the length of maturities, are in a position to essentially justify the risk premia that they have been charging.

After all, the function of that particular market price is to reflect the realities in this case. Therefore it does not strike me as being entirely out of the question or an untoward event that a rescheduling should occur in the case of Peru, which would stretch out the debt in a significant fashion. That is something for which the banks have already been paid, if you like, by virtue of the higher interest rates that they have received from these particular countries.

THE SHORT-TERM PROBLEMS

To turn to the short-term problems as they present themselves, certainly in the Mexican context it is clear that if Mexico is deprived of resources, it will find it very difficult to generate the exploration of petroleum resources that is necessary to repay the debt.

In a way the private market has already responded to this, as well as has the IMF. The original limitation on lending to Mexico has already been surpassed by the decision to rule out lending to PEMEX as being outside of the original agreement. It is the case that Mexico has been able to raise funds on the basis of the exploration.

Therefore I find myself reasonably sanguine about that particular situation. I think the strength of the peso in the future market con-

firms that, and despite the indications that there might have been some short-term capital flight immediately prior to the first anniversary of the devaluation of the peso, I think one has to interpret that as a market pattern of response which sometimes is irrational. There are such anniversary dates that are hallowed in financial circles and which require bankers to try to assure themselves that they will be protected. All indications are that that capital has not gone out of Mexico in any kind of continuous fashion or that the problem is a serious one.

Let me turn now to the question of policies, since I think we have outlined in some measure the nature of the complicated problem. In particular, I would stress that the developing country indebtedness problem is intimately related to the whole range of issues that make up the North-South agenda. We really cannot look at it entirely independently. Therefore the partial solutions that focus on the international credit market really do not do justice to it.

However, here let me try very briefly to talk a little bit about those policies in the context of the international capital markets.

RESTORING BALANCE

The problem, it seems to me, is to restore a better balance to development finance, a better balance in two senses: a better balance between official and private lending, and a better balance between short-term and long-term lending.

I think the extraordinary circumstances of the last few years have created an imbalance which it is in no one's interest to perpetuate. I think everyone is in substantial agreement on this particular matter.

The issue is how to restore that kind of balance.

A STEP IN THE RIGHT DIRECTION

The new IMF supplementary financing facility, which already has pledges of some \$10 billion, is a step in the right direction, particularly its extended repayment period. It will provide the Fund with a minimum amount of resources if it is to begin playing a role again in financial markets, compared to those of the private institutions.

I would, however, stress that the amount of resources that are involved are limited and will not come nearly to the total amounts that are required. Their importance resides in the fact that, at the margin, they can provide the additional flow of funds that will make it possible for countries to avoid excessively rapid adjustments and will also provide a basis for continuing private flows to those particular countries.

FACILITY ALONE IS NOT SUFFICIENT

However, I do not think that that facility alone is sufficient, nor do I think that it is sufficient to ignore the longer term development objectives in all of these countries.

I think it will be necessary to increase lending by the multilateral official banks. The role of the World Bank and the other regional banks in total capital flows to developing countries has shrunk dramatically as a consequence of the financing that has come from the private banking sector. That seems to me undesirable.

The official banks lend for longer periods of time and the official banks are in a position to have a longer perspective with regard to the developemnt of those particular countries than do the private banks. In large measure it has been accidentally that commercial banks have played the role that they have, an accident that occurred because of the rapidity with which the OPEC surpluses in fact accumulated consequent to the oil price increase.

A SWAP BETWEEN PRIVATE AND OFFICIAL BANKS

I have proposed that one method of increasing the participation of the official banks is to arrange a rather significant swap between the private commercial banks and the official banks; that is to say, that the World Bank would issue its bonds to private commercial banks and would, in turn, accept some of the portfolio of loans to developing countries that the commercial banks currently have outstanding.

It seems to me that this has the virtue of providing for the first time significant intermediation from the commercial banks to the official banks. Since the commercial banks are the ones in which the resources have been deposited, there has to be some way of getting them to the official banks.

WHAT KIND OF A BAILOUT IS THIS?

I do not believe that this is a simple bailout of the commercial banking sector for two reasons.

Senator CHURCH. What kind of a bailout is it? It may not be a simple one, but what kind is it?

Mr. FISHLOW. I think it is a bailout of the international financial system rather than a bailout of the commercial banks. I think it is very important to differentiate between the two. Ultimately the health of that international financial system is what makes it possible to inter-mediate the extraordinary imbalance in trade that has occurred since 1974. We really have had an unprecedented accumulation of surpluses in one set of countries and deficits in another.

Senator CHURCH. Do you see an end to that, say, in the next few years?

Mr. FISHLOW. I don't know. I think that is precisely the reason why one has to bail out the international financial system rather than bail out the commercial banks. But I think it is very important to differentiate between the two.

The sense in which I view it as a bailout of the international financial system is precisely that it restores much more of the balance in terms of providing official participation of a potentially longer term sort. When the commercial banks buy the bonds of the World Bank and the regional banking institutions, what they are doing is providing long-term resources to these particular institutions. Those bonds will have a maturity which is well greater than the short-term loan assets which they are turning over.

In the second sense, it is perfectly possible to arrange a swap in a fashion which enables the official banks to select out not merely those assets which are most endangered, but also the better earning assets which are not. So, it is not entirely up to the commercial banks to specify how that transfer would occur.

SHIFTING THE RISK

Senator CHURCH. Isn't this just a method of shifting the risk that has been assumed by the commercial banks to the World Bank?

Mr. FISHLOW. I suppose I would insist that it is inherent in the nature of financial intermediation that where there are the outstanding deficits and where those are, in fact, continuing, that those risks have to be shifted around in such a way as to minimize the possibility that the flow of debt will be irregular, will be subject to fluctuation, and to assure that it is a more certain kind of intermediation process that occurs.

Senator CHURCH. So, is your answer to my question "Yes?"

Mr. FISHLOW. Ultimately there is risk in any kind of situation in which there are loans, Mr. Chairman.

Senator CHURCH. Well, I know, but my question is a simple one.

WHERE DO YOU HAVE THE WORLD BANK?

Your proposal is one that would enable the commercial banks to shift a substantial part of their paper to the World Bank under terms that would benefit the commercial banks. But then you leave the World Bank in the same situation, it seems to me, from which you are trying to rescue the commercial banks.

Mr. FISHLOW. No, sir, I think not.

I think on the one hand the interest rate that would be paid on the World Bank loans that the commercial banks would obtain would be significantly smaller than the interest rate that one is talking about so far as their loans outstanding at the moment.

Second, they are of much longer term.

Third, the risk to the World Bank becomes substantially less because it is not faced with the same kind of "bunched short term" portfolio that one is talking about in the context of the commercial bank.

So, I think that in the process of such a transfer one, in fact, does achieve the objective which I think one does have to have, which is how to make international financial intermediation of those surpluses and deficits operate more effectively. That is the reality that I think one has to confront.

RESCHEDULING OF THE BANKS

We can obviously return to some part of that issue. I also pointed out that it seemed to me that one of the ways in which one does some of this adjustment is by having the commercial banks reschedule. One of the consequences of the high rates of interest that the commercial banks receive is an obligation, in a way, to reschedule as well. That is, after all, what a risk premium means.

Senator CHURCH. What would be the psychological impact of rescheduling? I accept your argument that earning a high interest on these loans, where rescheduling becomes necessary, they have been well paid for it. But what is the psychological impact, let's say, if Peru has to reschedule its debts? Does that have a cooling effect upon the extension of international credit generally to Third World countries?

Mr. FISHLOW. I think it probably cools the ardor for some marginal countries. But I think overall it probably does not have a significant effect. I have never been fond of dominoes when they applied in other contexts and I think it is inappropriate to apply them here as well.

Senator CHURCH. Thank you.

EXPANDING THE EXIMBANK

Mr. FISHLOW. The third suggestion that seems to me worth considering with regard to policy in terms of improved financial intermediation is the possibility of an expansion of the Export-Import Bank. The Exim would enable a larger official participation of a bilateral kind in international credit markets. Greater integration, in turn, of the Eximbank within the foreign economic policy of the country as a whole would provide, it seems to me, more financial leverage than currently does exist, and therefore, is a step that is worth considering.

Finally, I think as has already been recognized and pointed out by Secretary Blumenthal, it seems to me virtually inevitable in the next several years that there will be closer cooperation between the private banks and official agencies.

THE CRITICAL QUESTION OF COOPERATION

I think the critical question is how that cooperation evolves, as to whether the private banks dominate in the decisionmaking or whether the official agencies do, whether the association is only in terms of short term or whether the association is in longer term. I think there is a considerable experimentation that is necessary.

Let me only conclude by saying that I think the hearings are most opportune in the sense that it is important to point out that having weathered the first impact of the oil surpluses with less damage than many feared, it is essential that we now use the time that we have to begin thinking about these problems and devising new forms of intermediation that are more appropriate.

Senator CHURCH. Thank you very much for your testimony.

WITTEVEEN FACILITY AS FIRST STEP

You would regard the Witteveen Facility as the first step in the direction that we must now go to avoid serious problems in the future, is that not so?

Mr. FISHLOW. I think it is a first, and minimal, step.

Senator CHURCH. First and minimal. I see.

That is rather how I have regarded it. Your other suggestions, except for rescheduling, would face rather fierce political resistance, I think, because they would be regarded, with considerable reason, as a fancy way of bailing out the commercial banks for imprudent loans. Therefore it will not be easy, in my judgment, to accomplish.

Senator Sparkman, do you have any questions?

The CHAIRMAN. Thank you, Mr. Chairman. I just came to sit in. I am not a member of this subcommittee.

Senator CHURCH. You are, of course, most welcome at any time.

The CHAIRMAN. I did want to hear some of this testimony.

Let me ask just this question.

OUR SHARE OF THE FACILITY

I gather from the opening statement of the subcommittee chairman that the proposal is to increase the U.S. contribution to the International Monetary Fund, and that I believe you say is increased by \$10 billion.

Senator CHURCH. Yes. The Fund itself would be increased by \$10 billion.

The CHAIRMAN. Yes, and our share would be \$1.7 billion according to the statement.

Senator CHURCH. That is correct.

The CHAIRMAN. That is really what we are working on, isn't it?

Senator CHURCH. That's right. That is the Witteveen Facility and of course the agreement needs to be ratified by the Senate. But we are trying to put this in the perspective of the context of the whole economic problem that faces the Western World as a result of the vast annual surpluses that are piling up in countries like Saudi Arabia and the Emirate States.

THE SITUATION IN BRAZIL

The CHAIRMAN. I was interested in the lineup of the witnesses for today. I notice that the next witness is going to deal primarily with the situation in Brazil.

Senator CHURCH. We have changed the order of our witnesses, Mr. Chairman, but we do hope to hear about Brazil later this morning.

The CHAIRMAN. So then you will be taking Mr. Boeker next; is that right?

Senator CHURCH. Yes.

The CHAIRMAN. That will cover the OECD area, won't it?

Senator CHURCH. That's correct.

The CHAIRMAN. These are very interesting hearings, though I must say that this is over my head, all of this high finance. But this is a problem that we have to solve.

NO LONG-TERM SOLUTIONS

Senator CHURCH. Mr. Chairman, we have been looking for that solution and we have turned to the finest economists we could find. I must say that so far no one has presented what you would regard as a long-term solution. But I think the consensus certainly supports the Witteveen facility as a necessary step at this time.

The CHAIRMAN. Well, as I said, I am just interested in these hearings and though I am not a member of this subcommittee I did want to sit in.

Senator CHURCH. We are pleased and honored to have you here this morning, Mr. Chairman.

Mr. Fishlow, thank you very much for your appearance here today.

Our next witness is Paul Boeker, Deputy Assistant Secretary for the Bureau of Economic and Business Affairs of the Department of State.

Please proceed, Mr. Boeker.

STATEMENT OF HON. PAUL H. BOEKER, ACTING ASSISTANT SECRETARY FOR ECONOMIC AND BUSINESS AFFAIRS, DEPARTMENT OF STATE

Mr. BOEKER. Thank you, Mr. Chairman.

I appreciate the opportunity to appear before the subcommittee this morning to discuss issues related to the international monetary system. I would like to comment on recent developments in the world economy and on the large imbalances which now characterize international payments.

In viewing the international economic scene in 1977, the following conclusions appear warranted:

The international monetary system has performed well under the sudden strains that were imposed upon it by the shocks of 1973-75, including a sharp upsurge in costs and prices generally, a severe recession, and sharply higher oil prices. These shocks were contained in significant part because the international system enabled the countries to obtain the borrowings necessary to cushion the economic adjustments, enabling their impact to be distributed over a number of years.

Without adequate external financing, deficit countries would have been compelled to attempt an adjustment so abrupt that it would have imposed severe austerity on their populations and jeopardized the political stability of a number of countries.

THE IMPACT OF A SLOWDOWN

The impact of an abrupt slowdown of economic growth in deficit countries would quickly have spread to stronger economies, complicating world recovery. Given the alternative of a severe economic contraction, large-scale borrowing, from the systemic standpoint, can be considered to have been prudent.

LARGE IMBALANCE WILL LAST

Since it appears that large international payments imbalances will last at least through the end of the seventies, we face a period of prolonged economic adjustment and structural change. During this period, it will be important to assure a reasonable distribution of the payments deficits in accordance with the underlying productive potential of individual countries and their ability to sustain additional debt.

Yet we obviously cannot expect the current scale or distribution of borrowing to continue indefinitely. The current financial imbalance of the OPEC countries with the rest of the world must be reduced. Given the low absorptive capacity for imports of a few very important OPEC countries, this reduction cannot be accomplished fully without restraining industrial countries' imports of oil.

ENERGY ADJUSTMENT NECESSARY

Thus, the ultimate adjustment has to be an energy adjustment, not merely a financial one, and the President's proposal for a wide-ranging program to reduce U.S. dependency on imported oil remains the critical step toward preserving a stable international economy.

THE BROADER PERSPECTIVE

In broader perspective, the accomplishment of our foreign policy objectives depends in large measure on a strong and healthy world economy, underpinned by a viable international monetary system. The health of our own economy, which is increasingly influenced by international exchange, obviously bolsters in turn an effective U.S. foreign policy.

While the international monetary system is basically sound, this does not justify a judgment or policy of complacency. Care must be taken to insure that individual country situations are treated efficiently and in the context of global economic circumstances.

In particular, we need to recognize that the large payments imbalances have created a quite different world environment than that of the past, and that the task of backstopping the world financial system now entails greater responsibilities for a larger group of countries.

Many countries have adopted policies which are bringing their balance of payments into a sustainable pattern. In other countries, however, stabilization programs have achieved only limited progress so far and additional time is necessary to restore equilibrium.

There are other countries which still face large deficits but have only begun to develop appropriate adjustment policies. Unless adjustments are made in individual country circumstances, they will not be able to obtain the financing they need and thus could be forced into taking disruptive measures which would be harmful to their own economies and societies and to the world in general.

Some of the most difficult adjustment problems are found among the industrial democracies. Several of the larger countries of the OECD have experienced large payments deficits over the past few years.

THE CURRENT PAYMENT SITUATION

Another prominent feature of the current payment situation is the large and persistent current account deficits attributable to the smaller industrial economies and other countries of the OECD.

Last year, the current account deficit of 12 smaller OECD economies, which ran at about \$14 billion in 1974 and 1975, widened to over \$18 billion. Only a marginal improvement in this situation is to be expected during the current year.

While the collective deficit of these smaller OECD economies rose sharply with the onset of the global recession and the oil crisis, a major impact of the events of 1973 to 1975 was to intensify fundamental weaknesses already inherent in individual country economies. While some countries attempt the necessary and often difficult steps to adjust, others discovered that they were unable to do so, mainly because of domestic economic and political factors.

Individual country efforts to maintain employment and social benefits led to a more rapid expansion of domestic demand in the smaller OECD economies generally than in the larger ones, and rising production costs made their exports less competitive.

EFFECTS ON OECD COUNTRIES

The cumulative deterioration of the terms of trade of the smaller OECD countries since 1973 has, moreover, been greater for that than for any other major group of countries. Rapid political change in some countries also complicated the adjustment process and impelled some countries to seek a longer horizon for economic adjustment than might otherwise have been possible.

In general, I think we have seen from the experience of recent years that rapid economic adjustment is a task in which young democracies face particular constraints that need to be recognized if the adjustment process is to take place in an atmosphere that achieves essential political and social objectives as well as the objective of economic stability.

THE PORTUGUESE SITUATION

While there is great diversity among the economies of the smaller OECD countries, the situation in Portugal has been illustrative at least of a variety of factors, including but by no means confined to, oil, which have defined the adjustment problem.

The 1974 revolution in Portugal destroyed old political structures but did not, for a number of years, provide a firm political-economic base to cope with a rapidly changing situation. The resulting political instability of 1975 and 1976 exacerbated economic disruptions, and further reduced output at a time when demands were greatest.

Capital flight in the year or so after the revolution was quite large. The political-economic challenge was further increased by the return to Portugal of over half a million refugees from the colonies, a virtually total loss of export markets in the former territories, and a sharp drop in foreign tourism and emigrant remittances, both crucial elements of the Portuguese balance-of-payments situation.

As a result of these events, some of them linked to problems in the world economy, some of them linked to events peculiar to Portugal, Portugal had to embark on an economic adjustment strategy that clearly could achieve its objectives only over a horizon of several years and with considerable external financing.

In the absence of something like the proposed supplementary financing facility in the International Monetary Fund, the community of concerned countries readily agreed that extraordinary balance of payments financing was required, even given the best of economic adjustment efforts on the part of the Government of Portugal.

Thus, a \$750 million multilateral financing program for Portugal has been concluded, and includes a \$300 million U.S. contribution approved by the House and the Senate.

As successful as we hope this effort will be, it is clear that this ad hoc approach obviously cannot be repeated in a number of countries in the future. A more systematic, multilateral approach, with appropriate burden sharing, is needed.

The financial condition of OECD countries is a pivotal element affecting a broad range of U.S. foreign policy objectives. Yet the situation of many industrial countries is now characterized by only moderate growth with varying combinations of high unemployment and inflation.

CONSENSUS AMONG OECD COUNTRIES

It is encouraging, however, that there is a unanimous consensus among OECD countries that a retreat into purely nationalistic economic policies would be self-defeating. The United States and other countries are therefore committed strongly to the maintenance of an open and cooperative economic system.

This entails specific responsibilities on all member states, particularly on the stronger economies. To insure that our system is able to continue functioning effectively, deficit countries must be given an opportunity to adjust their economies at a pace consistent with the realities of their social, political, and economic situations. Indeed, such adjustment measures are essential elements for any program geared to longer term economic growth and employment, and delays in dealing with them could be costly.

The availability of external financing sufficient to cushion the necessary adjustment will be a critical element for the continued efficient operation of the monetary system. Private capital markets have provided the great hulk of balance of payment financing to deficit countries. This trend is expected to continue in the period ahead.

But because some individual countries may not be able to obtain all the financing required from the private market, there is also a critical need for adequate official financing to support and encourage adjustment programs.

AN ESSENTIAL PURPOSE OF THE IMF

An essential purpose of the IMF is to provide members with an opportunity to correct maladjustments in their external sector—subject to adequate conditioning—and to help them do so without resort to protectionist measures. IMF borrowings in the 1974 to 1976 period totaled about \$15 billion, or roughly 7 percent of total financing extended over that period.

Adjustment needs remain large. At the same time, the IMF's greatly increased activity has caused a rundown of its available resources.

IMF usable resources are at present quite low at about \$5 billion. These usable resources will be increased by about \$6 billion or \$7 billion with the coming into effect of the sixth quota review. In addition, about \$3 billion remains uncommitted through the general arrangements to borrow.

In the period ahead, need for IMF lending may well be greater. For this reason, the administration has strongly urged Congress to authorize U.S. participation in the IMF Supplementary Financing Facility. This facility is necessary to assure that the IMF has adequate resources to meet potential official financing needs, to encourage countries to adopt the corrective policies that are associated with IMF standby arrangements, and to provide the confidence that is necessary for adequate functioning of international financial markets generally and for private financing which should remain the principal source of financing.

By showing that the major countries, both industrial nations and OPEC members, are cooperating to enhance the well-being of other countries and the stability of the international economic system, this new facility should make an important contribution to international stability and progress.

Thank you, Mr. Chairman.
 Senator CHURCH. Thank you, Mr. Boeker.
 I just have one question.

THE CURRENT BALANCES

The chart that has been put up showing current balances of OPEC, OECD, and non-oil-developing countries is a rather striking illustration of the problem. There was a \$66 billion OPEC surplus in 1974 and a \$33 billion deficit among the OECD countries, and a \$21.5 billion deficit among the nonoil LDC's.

The deficit for the lesser developed countries remains rather constant. But the deficit for the OECD countries changed very markedly between 1974, 1975, and 1976. What accounts for that, do you know?

Mr. BOEKER. Well, Senator, I think there are a number of factors that account for that.

One of the factors is that when the initial shock hit, the peaking of business activity and beginning of the recession in the OECD area, and dramatically increased oil prices, it was the developing countries, I think, which at that historical moment found themselves least able to make very quick adjustments in terms of reducing their import demand.

Historically they may have had some basis for feeling that rapid adjustment may not have been necessary since some of the larger developing countries have historically not been in sort of the same business cycle phase as the OECD countries. They have been able to maintain a more constant level of business activity despite recession in the major industrial countries.

So, they were slower to react both for economic and historical reasons than the industrial countries and the immediate effect of that was that a large share of the deficit fell on them. It was only in the following year that some of the largest of the developing countries really faced and recognized clearly the need for stabilization and adjustment measures on their part.

THE EFFECTS OF THE RECESSION

Senator CHURCH. Are we seeing on that chart the effects of the recession in the industrialized world?

Mr. BOEKER. Yes.

Senator CHURCH. Isn't that really the reason for such a fluctuation? The recession came on in the aftermath of a 400-percent increase in the oil price that was imposed in 1974, and that recession reduced the demand for oil and thus the deficit incurred for oil purchases in 1975. Then you see in 1976 the beginnings of a recovery in the industrialized world which, in turn, has increased the demand for oil, and thus the deficit increases again.

That may be too simplified an answer, but don't you think that is one of the principal factors of the fluctuation?

Mr. BOEKER. Yes; it is. The difference there between the developing and industrial countries is, I think, that there is more of a cyclical element in the imported energy demand of the industrial countries than of the developing countries. Another fact I think that is clearly seen there is the course of commodity prices, which had a very

unfavorable effect on developing country exports in 1974 and a somewhat more favorable effect in 1975 and 1976.

DIVISION OF COUNTRIES

Senator CHURCH. The other chart to which I would like to call attention divides the OECD countries between the strong economies, the group I countries, and the weak economies, the other remaining members of the OECD.

Notice that the group I countries includes the United States, Japan, Germany, Canada, Belgium, The Netherlands, Norway, and Switzerland. Those are the strongest countries of the group in terms of their economies. You get a surplus in 1974, 1975, and 1976 if you combine those countries together. The deficit is concentrated among the weaker countries in the OECD.

Well, that is not an astonishing revelation.

The political implications of it all are very disturbing. As to the extent that it requires severe austerity programs to deal with these deficits, there could be very unfortunate political consequences.

Senator JAVITS, do you have any questions?

COMMENTS BY SENATOR JAVITS

Senator JAVITS. Yes, Mr. Chairman. Thank you. I will be very brief.

First, I am sorry to be late, but there was another hearing that required my presence. But I have a pretty good idea as to what the witnesses are testifying to.

Mr. Chairman, I would like to include in the record a piece out of the London Economist current issue entitled, "Rich Cousins Getting Poorer." This goes to exactly this problem of the OECD countries.

I am puzzled about two things with which I would like your help.

WHERE ARE WE ON THE SAFETY NET?

One is your statement on page 7, at the end of the unfinished paragraph. You say, "A systemic, multilateral approach, with appropriate burden sharing is needed."

This was what the safety net was all about and that has been apparently dropped right down the tube by the State Department. So where are we on that? If there is going to be something else, what do you recommend as a "systemic, multilateral approach with appropriate burden sharing?"

Mr. BOEKER. I think the objective of the OECD's safety net and of the IMF supplementary financing facility was very similar in this regard.

Senator JAVITS. The IMF supplementary financing facility is how much?

Mr. BOEKER. The IMF supplementary financing facility is going to be about \$10 billion.

Senator JAVITS. That is Witteveen.

Mr. BOEKER. That's correct.

Senator JAVITS. That's what you mean by the supplementary?

Mr. BOEKER. That's correct.

The usable resources of the safety net, as it was originally proposed, would not have been much different.

The proposal had a \$25 billion price tag on it, but since it was a mutual pool, its usable resources were about half of that.

Senator JAVITS. Would you submit a statement as to that, because that is a big question? Let's have a statement for the record as to why the Witteveen is about the same, that is, in the eyes of the State Department.¹

Mr. BOEKER. The total amount of resources available would be not much difference. But there is a significant difference in the country coverage, which is one of the factors that led the administration to seek to pursue this approach.

THE ADMINISTRATION APPROACH

Senator JAVITS. What is this approach?

Mr. BOEKER. This approach would be available for all countries who are members of the IMF; that is, it would be available for the developing countries as well as for the industrial countries of the OECD.

The other quite significant difference is in terms of the people that would be putting up the resources. In the IMF facility, the Witteveen Facility, the OPEC countries would be putting up close to half of the resources. Under the OECD safety net proposal, all of the funds would be provided by member countries of the OECD.

WHAT IS THE STATE DEPARTMENT'S RECOMMENDATION?

Senator JAVITS. I know that. I do not mean to press you or cross-examine you, but I would like to get an answer. What is the State Department recommending as a "systemic, multilateral approach," outside of Witteveen and outside of the safety net?

Mr. BOEKER. What I meant to indicate there is that we view the Witteveen proposal, which is what we are strongly recommending, as an essential part of a systemic, multilateral approach. Clearly the Witteveen facility is not the ultimate answer dealing for many years ahead with international payments problems; but we think it is an essential step at this time and we feel it will provide an adequate response to financing needs for several years to come.

Senator JAVITS. Notwithstanding the projections? It looks like we are talking about \$150 to \$200 billion, even projected to 1985 only. Even assuming that the price of oil remains the same and inflation does not get any worse, are you telling us that those amounts are remotely comparable, especially as you are already restraining and constraining the commercial channels and many countries are already loaned up? Are you seriously telling us that \$10 billion is going to be enough?

THE MIX BETWEEN OFFICIAL AND PRIVATE FINANCING

Mr. BOEKER. The important thing, Senator, is the mix between official and private financing. I think in a well-functioning system, the great bulk of the financing available is now, and should be in the

¹ The statement is being retained in subcommittee files.

future, coming from private sources. One of the critical functions of the official finance is to help assure a stable enough underpinning so that the private financing is available and flows through normal capital market channels. That is one of the critical functions of the International Monetary Fund, to provide the policy environment, in terms of economic performance of borrowing countries, and to provide sort of a financial underpinning in terms of ultimately available official resources, to provide a stable system generally. In such a stable system we feel that adequate private financing will do the rest of the job.

The judgment is that a \$10 billion Witteveen Facility, on top of the financial resources that are already available to the IMF and that will be available from other sources will be adequate in terms of the official side of that proposition, that is, providing a demonstrably adequate amount of official financing to assure a stable underpinning for the system generally.

INCREASING THE CAPITAL OF THE IMF

Senator JAVITS. Is there any thought about increasing the capital of the IMF?

Mr. BOEKER. The IMF quotas are reviewed every 3 to 5 years. There is a quota increase that is now in process awaiting the adequate number of ratifications from member governments, and we hope it would come into effect next year.

Senator JAVITS. This quota increase is from what to what?

Mr. BOEKER. This quota increase would make available to the IMF about \$7 billion in additional usable resources.

Senator JAVITS. This makes a total of what?

Mr. BOEKER. The total quotas of members of the Fund?

Senator JAVITS. No; over and above what it is today. How much is that going to be?

Mr. BOEKER. I think that the clearest way to look at what I think you are interested in is to think in terms of the IMF now having under the present quotas about \$5 billion in additional resources which it can use and has not yet done so. The Witteveen facility would add \$10 billion on top of that. As soon as adequate ratifications are secured for the quota increase, that adds another \$7 billion on top of that. Then the IMF also has available an additional \$3 billion under the longstanding general arrangements.

So, if you want to look at what the IMF will have available—

Senator JAVITS. It will be about \$25 billion.

Mr. BOEKER. That's right. That is what the IMF will have available in coming years.

Now quotas will again be reviewed in coming years in a process that should start next year. There certainly will be another quota increase in the IMF, I would suspect, that a couple of years down the line would come into effect and further replenish those resources.

Senator JAVITS. Have you come to Congress yet for the \$7 billion?

Mr. BOEKER. Yes.

Senator JAVITS. In other words, we have a pending request for legislation?

Mr. BOEKER. No, sir, the United States is among those countries that has already ratified.

Senator JAVITS. We have ratified?

Mr. BOEKER. Yes, we have ratified.

A BENIGN CONSPIRACY

Senator JAVITS. I have just one other question, but first I want to say this: I hope very much that the State Department and the Treasury Department, thinking that complacency is what is going to reassure markets, are not going to mislead us, not in an active sense, but by their silence. I personally get the impression that by one of those benign conspiracies of the executive department nobody is really putting the case to the American people. It just does not add up to me. You are counting on commercial lending to the extent of two-thirds and I think you are really going to come up against a brick wall with what you expect in commercial lending.

A MESSAGE TO STATE

I would urge the State Department and the Treasury Department to review the bidding, quite apart from all the other things they have to do, and to come to the American people with a real bill. I think they will respond much better than with these superficial assurances that, well, Church, Javits, and others read the same signs that we do, but they read them differently because we think it is OK. Now it just is not OK and there is no evidence to sustain that it is OK.

I cannot impress that upon you enough.

I know, you don't make the policy, but you speak for the Department. I think it is very essential that this message be taken back to it.

Finally, I have a question.

CONSERVATION IS GETTING NOWHERE

In your statement you say the following:

Thus the ultimate adjustment is an energy adjustment, not a financial one, and the President's proposal for a wide-ranging program to reduce United States' dependency on imported oil remains the critical step toward preserving a stable international economy.

Now my dear friend, if that is what you are counting on, forget it. That is my message to you and the State Department. Conservation—disgracefully, unhappily, and shamefully—is getting nowhere. If the financial viability of the world is going to depend on your expectation of that, you certainly need to review the bidding or we are going to be in for one terrible crash and disappointment.

Senator CHURCH. I could not have made that last point better myself, Senator Javits.

REDUCING DEPENDENCY

Mr. BOEKER. Senator, on that last point, when I talked about reduced import dependency, I did not mean to reflect any pessimism on conservation efforts and I hope that full pessimism there is not warranted. But I by no means meant to exclude reducing import dependency by increasing energy production as well.

Senator CHURCH. Certainly we will hope that we can do better in the future than has been done up until now, though the votes in the Senate would not seem to bear that out. [General laughter.]

REALITY WILL PREVAIL

Even if we do manage to reduce our demand for OPEC oil, either through better conservation or through the development of alternative sources—the Alaskan oil is coming in and hopefully we will be expanding use of coal and nuclear power must play a central role beyond the limitations imposed on it now by the administration—reality ultimately will prevail.

Just supposing that we do manage and the amount of our present imports from the OPEC countries is reduced. It is anticipated that normally it would be true in a free market that the reduction of that demand would have an effect upon price. It would temper the price; it might lower the price. It should and in a free market it would.

OPEC IS NOT A FREE MARKET

Since OPEC is not a free market but rather the most successful international cartel in history, and since Saudi Arabia has more money than it knows what to do with, and is less certain that the value of that money will be sustained in the future than it is that the value of its oil in the ground will be sustained in the future, can we really expect that a lower demand for oil will have the effect of tempering prices and reducing these surpluses? The surpluses created such problems, and are the basis for the disequilibrium in the world economy.

Just why do we expect that?

Yesterday Secretary Solomon said that he was quite certain that if the demand for oil had been significantly reduced, prices today for oil would be lower. I don't understand the basis for that certainty. All that Saudi Arabia has to do is turn the value. If it turns the value back, it keeps that much more oil in the ground, reduces the production, and through the cartel the price can be further increased so that the surplus can be maintained.

A BANKRUPTCY IN OUR THINKING

It seems to me that there is a bankruptcy not so much in the financial markets yet as in our thinking about this problem and in our refusal to confront it. We just talk about how we are going to shift the debts around, about how we are going to get more credit to take care of them this year and next.

I absolutely fail to see in any of this testimony anybody confronting the underlying issue, which is the power of the OPEC cartel and its continuing impact on the Western World.

Senator JAVITS. Would the Chair yield?

Senator CHURCH. Yes.

MAKING A DEAL WITH OPEC

Senator JAVITS. Mr. Boeker, I don't want to leave you up in the air as to my attitude. My attitude is—and Senator Church is obviously

extremely well able to speak for himself—that an essential element here is you have to make a deal with the OPEC countries. We have to use our economic, our political, and our diplomatic muscle, if need be, to do it. You cannot do it without that. The commercial banks are going to disappoint you.

Now they are not going to say that and of course I cannot speak for them. But as I read the tea leaves, it cannot go any other way. You are counting too heavily upon that.

Therefore the preparations for an international backup in the IMF need to be quicker and, as much as we can make them, maybe \$25 billion is the limit. You have to make a deal, a proper financial deal. They control this pool of capital, which is much more dependable, and we must give them international guarantees. If they are stretched out enough in years, we can make it. Give us 30 years and we will work this out. In 30 years they will be out and they will need the money, they will need the new investments and new energy sources. We can afford to guarantee they will get it.

But, without that kind of comprehensive structure, I don't think so.

The chairman and I thoroughly agree. We have been listening to everything. Believe me, we are on your side. We are not really looking for trouble.

Thank you, Mr. Chairman.

THE ECONOMIC REALITIES

Mr. BOEKER. Mr. Chairman, may I just say that I think from the other side, without disagreeing completely with what the Senator has said, we certainly don't want to hold out the prospect of negotiated or political solutions to economic realities because there are very strong and stark economic realities that underpin the effectiveness of OPEC. With the best of political strategies I don't quite see how one can imagine changing them without fundamentally affecting the economics as well.

So, in the end, I am afraid that the fact remains that a critical part of a more stable situation remains the economic realities of our energy use, the energy use of the industrial countries, and the limited capacity of the oil producers to import sufficient goods to cover our bills for oil. Unless we can effect a fundamental change of direction over time in that imbalance, it is difficult to see how the power of the cartel—if you want to look at it that way—or any of the other basic factors, is going to be changed without a change in the underlying economic realities.

Senator JAVITS. Mr. Boeker, please follow me, now. Again, I will say that we are on your side. We are not against you.

COMPELLING SMALL NATIONS TO REFLATE

But, as the matter stands now, you are compelling the many small industrial nations to whom you particularly addressed your point to reflate. They have to retrench, they have to pull in, they cannot have as many imports, and so on.

What I am saying is that this is very bad for the world. You are not going to get anywhere in Geneva with the multilateral trade nego-

tiations and so on soon enough to counter that trend unless you give them a bigger credit pool that is more dependable. That is really all I am talking about. If you people have any better ideas as to how it can be attained, we will welcome them certainly.

Mr. BOEKER. I agree entirely with that. The assurance of available and adequate financing is critical.

Senator CHURCH. Now we are back in the same circle. I think we have gone over it several times. It remains a circle.

Mr. Boeker, we want to thank you for your appearance here today before this subcommittee. We appreciate your efforts.

INTRODUCTION OF MR. RIORDAN ROETT

Our last witness today is Mr. Riordan Roett, director of Latin American studies, the Johns Hopkins School of Advanced International Studies, Washington, D.C.

Mr. Roett, we understand that you are going to discuss the Brazilian situation, is that not correct?

Mr. ROETT. That is right, Senator.

Senator CHURCH. Very well, we welcome you before the subcommittee today.

Would you please proceed with your testimony.

STATEMENT OF RIORDAN ROETT, DIRECTOR OF LATIN AMERICAN STUDIES, THE JOHNS HOPKINS SCHOOL OF ADVANCED INTERNATIONAL STUDIES, WASHINGTON, D.C.

Mr. ROETT. I bring you not the wisdom of the economists, Mr. Chairman, but the skepticism of the political scientists about this whole question of foreign debt and the imagination of the administration in responding to what I believe to be an increasingly serious political situation in the countries of the Third World, and particularly in Brazil, a country I have had a great deal of exposure to during the last 17 or 18 years.

THE POSSIBILITY OF LIBERALIZATION IN BRAZIL

There does seem to me at the present time—as I say in my prepared statement which I will not read—to be the possibility of an opening, a liberalization in Brazil, for the first time since 1964. In that context, the imposition of rigorous schedules of dealing with the foreign debt in a period of political transition could well impose impossible political strains upon the Brazilian political system.

One should enlarge this question and this discussion, it seems to me, to open a debate which I have not heard very much about within the U.S. Government about the political implications internally in the Third World countries of whatever standards are established internationally for dealing with the foreign debt.

A BAND-AID RESPONSE

It is insufficient, it seems to me, to merely talk about IMF strategies, \$9 billion or \$10 billion standby "band-aid" responses, when one is not

dealing with the overall political implications internally and that linkage, then, to the international political system which is of absolute importance in addressing this question of the foreign debt.

The Brazilian case is instructive here, I believe.

The relationship of the United States with Brazil is at the present time heavily strained. It is clear that the internal implications of foreign debt management have not been dealt with at any great length by the administration.

It is also clear that the implications in the 1980's will be even more serious if indeed the Brazilian commitment to return to a competitive political system is accomplished during the next 3 to 5 years.

THE ECONOMIC IMPORTANCE IN THE DATA

It seems to me that Brazil, given its economic importance in the data which your committee has assembled, demonstrates both the positive aspects of Brazilian industrial growth as well as the negative aspects, such as the size of the foreign debt. A very careful review of U.S. policy toward Brazil is necessary and clearly the foreign debt looms large in that review and in that reassessment of U.S. policy dealing with Brazil.

We tend to maintain old stereotypes. The old stereotype of Brazil as a military dictatorship, as a typical banana republic, still holds, unfortunately, for some people in Washington. This is absolutely not true.

We are dealing with Brazil in a period of rapid expansion, which has now leveled off and indeed declined slightly, with a country which is responsive to international economic stimuli. More important, we are dealing with a country, when talking about Brazil, that has always maintained a high level of civilian participation in economic decision-making.

If, during the transition back to a more responsive political system, the civilian decisionmakers are burdened with an impossible burden—that is, responding to the long-term and short-term foreign debt implications of repayment—then we are confronted with a situation in which the civilian leadership will indeed be challenged beyond its capacity to respond to make an open system function.

I therefore address my remarks to that very serious problem, which I have not seen discussed or analyzed, of how a Third World country of the significance and importance of Brazil will be able to deal, if a political transition is taking place, with the burden of foreign debt management without leadership and without cooperation from the industrialized countries.

One can make the argument, even if we are not moving into a period of political liberalization and normalization in Brazil, that there are very clear signs that the economy, the internal economic situation which has clear social overtones, will need to receive far greater attention from the Government that takes power in 1979.

THE FOREIGN DEBT QUESTION

The foreign debt question, which is of growing concern and debate within Brazil, therefore requires even more careful monitoring and more careful attention.

Let me merely close this opening comment by saying that Brazil is and should be instructive. It is a nation which I find to be absolutely essential to the future relations of the United States, both in this hemisphere and in the Third World. The foreign debt question is one that looms very large in the internal politics and the transition back towards normalcy in Brazil, and I have not seen these questions addressed. Therefore I applaud the possibilities of discussing the political implications with the subcommittee.

Senator CHURCH. What is the answer?

Mr. ROETT. The answer is one that cannot be found in Brazil.

Brazil is dependent upon national leadership. It is dependent upon a more comprehensive response to the debt question and to the issues that the debt question poses.

A STRONGER DIALOG NEEDED

What is required, it seems to me, in part is a far stronger and more frank dialog between the United States and Brazil, and between countries like Brazil. There are a group of six or eight countries in the third world which have peculiar and particular foreign debt problems and which are also emerging industrial powers. Between those countries, perhaps, and the international organizations, as well as the industrialized countries, a dialog should ensue.

The response should not be and cannot be a momentary and short-term response, and, more importantly, it cannot be a fiscal and monetary response. It must be a response that understands the political context within which the foreign debt is being dealt with in Brazil.

THE PRINCIPAL CAUSE OF FOREIGN DEBT

Senator CHURCH. What is the principal cause of the mounting foreign debt in Brazil?

Mr. ROETT. I think, as Professor Fishlow very well pointed out, it is the post-1973-74 burden of petroleum imports. As you well know, Brazil is dependent to about 85 percent on oil imports.

Senator CHURCH. If you trace American policy with Brazil, you start with a country with about 85 percent of its energy derived from imported oil. Brazil attempted to establish an alternative source for generating electricity by launching an ambitious nuclear program. Then we told Brazil that its effort to break its dependence upon importing foreign oil must follow its course that will make it depend upon a new foreign source for natural uranium, equally susceptible to cartelization.

When Brazil finds that unsatisfactory, as I think we would if we were in her situation and confronted with her problems, we do everything that we can to block the sale of a breeder reactor or a fuel system that would provide an internal source of energy supply.

So, it is no wonder that our relations with Brazil are strained.

SUBSTITUTING ONE DEPENDENCE FOR ANOTHER

It is also no wonder that the world is simply refusing to follow our leadership in the nuclear field. It is not only just Brazil and Western

Europe, but also Japan and other countries that must seek a nuclear technology that will give them an internal base for energy, or they will just have to substitute one dependency for another and still remain helpless if their imports are cut off, unable to control either the supply or the price.

I think our policies, if they are going to be successful in the world, have to show some understanding for the problems that other countries face. I wonder how long it will take us to make that adjustment.

Mr. ROETT. If I may comment, you raise a very important point in that there is insufficient understanding in the United States of, first, Brazilian nationalism. They, too, are entitled to be nationalistic since we are, in large degree. Second, they have also changed tremendously since 1964, when Ambassador Gordon ordered battleships off the coast of Brazil to support the military revolution.

It seems to me that we are dealing with a highly sophisticated and increasingly complicated country that occupies a very important role in the Third World and therefore it is one that deserves careful attention in the United States, and it has not yet received that attention. More importantly, the diversification of dependence is a question and a theme that is widely debated and discussed in Brazil itself. The lack of response from the United States has been very duly noted by the Brazilians. Now I am not merely talking about the Brazilian Government. I think I speak fairly when I say that it is discussed at various levels of Brazilian society.

The blindness of the United States in this area is indeed endangering a relationship that goes back into the last century and is an extremely important one.

COFFEE AND OIL

Senator CHURCH. And we are dealing, insofar as Brazil is concerned, with the giant of South America. Its position in South America is comparable to that occupied by China in Asia.

As the external debt has mounted for Brazil, caused in the main by the spiraling cost of oil imports, so the price of coffee has jumped up 500 percent. Do you see any relationship between the two?

Mr. ROETT. It is alleged, of course, that one defends oneself with what weapons one has at hand. We have also seen a tremendous responsiveness in the Brazil agricultural sector since 1973-74 to respond to the realities of world conditions; that is, to generate high levels of commodity exports to earn the income required to deal with the oil price problem. Therefore, coffee, soybeans, and citrus fruits are all part of that. Coffee, being the traditional export of Brazil, occupies a place very dear to Brazilian exporters and to the international commodity system.

It does not surprise me in the least that the Brazilians have used as a weapon one of their strong cards since 1973-74, that is, their capability of responding to an international demand for commodities, given the leveling off of demand for industrial products and the high cost of imports for Brazil.

Senator CHURCH. Senator Clark, do you have any questions?

Senator CLARK. Yes, Mr. Chairman, thank you. I have just one question in that regard which I will ask quickly.

THE DEMAND FOR COMMODITIES

The demand for commodities in 1973-74, which went on into 1975 and to some degree 1976, has now been turned around significantly and surpluses are beginning to build, at least in the United States and to some degree in other areas.

Mr. ROETT. That's right.

Senator CLARK. Can Brazil compete in international commodity areas, in this case in agricultural areas, such as soybeans, corn, and other things, in a down market, in a market in which the overseas sales are somewhat below the costs of production as far as American producers are concerned?

Will they be able to continue to expand their agricultural economy in that kind of international economic climate, or not?

Mr. ROETT. I cannot give you a definitive answer to that since I am not an economist nor am I totally abreast of the intricacies of international commodity production.

Brazil can certainly go far towards subsidizing production and providing internal supports. But there is a point beyond which the economy and the decisionmaking apparatus cannot provide that kind of backup. Therefore they will be, once again, dependent upon international demands, market demands, as they have been traditionally.

In boom times they benefit tremendously; clearly in leveling off or declining times they suffer, relatively speaking, with other commodity producers.

Senator CLARK. Let me ask one other question which is unrelated to that one.

BRAZILIAN NATIONALISM

You spoke of Brazilian nationalism. Is there a stronger sense of nationalism in Brazil—and I see you are Director of Latin American Studies? Is there a stronger emphasis and trend toward emphasizing nationalism than there would have been 10, 20, or 30 years ago?

Mr. ROETT. I think there is.

I think that the nuclear development issue illustrates that rather well. Even the groups which oppose the present government in Brazil, such as the opposition parties and groups that have been traditionally in conflict with the Government's political policies, rally behind the government in its defense of its nuclear development program primarily because they felt this was an affront and an insult to their own development and their attempts to move away from dependence.

One finds that the Brazilians are an increasingly sophisticated, increasingly urban, and increasingly educated people, and are therefore in part increasingly aware of their own role in the world and their own capabilities in the international system. Therefore they cannot be dealt with in a dependent and distant position.

THE REST OF LATIN AMERICA

Senator CLARK. What about the remainder of Latin America? Can you generalize about that? Is there an increasing nationalistic feeling?

Mr. ROETT. That is a bit more difficult to respond to. Certainly in the major countries there is no doubt that there is an increasing sense of awareness, and with that increasing sense of awareness there is

a feeling somewhat of frustration in not being able to manipulate or deal with the international realities, political as well as economic, which can create—though I am not saying it has—a somewhat difficult, if not dangerous, situation in the future, politically, particularly, which I am competent to speak to.

Senator CLARK. This is certainly true in Africa and Asia and in other parts of the world, probably in Europe as well. It seems to me that if that increasing nationalistic attitude continues to increase, it will be more and more difficult to deal effectively in international relations.

Mr. ROETT. I think it is important to back up your point that nationalism is not something which is possessed merely by military governments. It is also something which is very characteristic, increasingly, of civilian governments, and, in fact, at times more strongly so. So, the United States should not make the mistake of believing that nationalism is attached to any one particular kind of government or regime. As development progresses, particularly in Latin America, which occupies a special role in the Third World, I think we will need to deal increasingly in our international economic and political relations with a self-assertiveness—not an aggressiveness, but a self-assertiveness—on the part of countries like Brazil. I find this to be entirely healthy. Therefore I find it difficult to understand the lack of understanding in the United States not only about the Brazilian position regarding their dependence, but also about Brazilian nationalism and its own view of the role of Brazil in the international system in the future.

THE GROWTH OF NATIONALISM

Senator CLARK. Do you find the growth of Brazilian nationalism, instead of nationalism in general, to be a healthy phenomenon?

Mr. ROETT. Yes, I do. It is not negative nationalism. I think a sense of pride is a capacity to respond increasingly to the realities of the international system and a capacity also to review policies and look for new policies that will be responsive and protective at the same time of the core interests which the Brazilians have long identified but have only recently moved into a position to begin to defend economically and politically.

I think it is certainly very much in the interests of the United States to be increasingly sensitive and responsive to Brazil, particularly, and certainly to Latin America in general.

Senator CLARK. Should we be increasingly nationalistic for the same reasons, in your judgment?

Mr. ROETT. The United States?

Senator CLARK. Yes.

NATIONALISM IN THE UNITED STATES

Mr. ROETT. It seems to me that certainly the level of nationalism in the United States is more than sufficient to serve our needs at the present time.

Senator CLARK. Thank you.

Mr. ROETT. You're welcome, Senator.

Senator CHURCH. Mr. Roett, thank you very much. I think we have come to the end of our morning.

We appreciate your contribution, Mr. Roett, as well as that of the other witnesses today.

The committee has three more hearings on the Witteveen facility so that means we are certainly going to give it adequate coverage.

Are those hearings scheduled for next week?

Ms. LISSAKERS. No, Senator. They are scheduled for the week after next.

Senator CHURCH. I think the Panama Canal hearings are scheduled for next week.

Very well, we will look forward to the following week to resume these hearings.

This subcommittee is hereby adjourned.

[Whereupon, at 12:01 p.m., the subcommittee adjourned, to reconvene upon the call of the Chair.]

THE WITTEVEEN FACILITY AND THE OPEC FINANCIAL SURPLUSES

THURSDAY, OCTOBER 6, 1977

UNITED STATES SENATE,
SUBCOMMITTEE ON FOREIGN ECONOMIC POLICY
OF THE COMMITTEE ON FOREIGN RELATIONS,
Washington, D.C.

The committee met, pursuant to notice, at 10:14 a.m., in room 4221, Dirksen Senate Office Building, Hon. Paul Sarbanes presiding.

Present: Senators Sarbanes, Clark, Case, and Javits.

Also present: Jerome Levinson, chief counsel.

Senator SARBANES. The subcommittee will please come to order.

Mr. Heginbotham, would you please proceed? I believe you have an outline of your testimony which I gather you intend to follow.

Mr. HEGINBOTHAM. That is correct, sir. I thought I would just hit a few high points. I thought it would not be worth the subcommittee's time to go through my testimony word by word. I will just touch on some of the high points.

Senator SARBANES. That sounds like a sensible way to proceed. Why don't you go ahead?

Before you begin, would you identify yourself and your position?

STATEMENT OF ERLAND HEGINBOTHAM, DEPUTY ASSISTANT SECRETARY, BUREAU OF EAST ASIAN AND PACIFIC AFFAIRS, DEPARTMENT OF STATE, ACCOMPANIED BY EDWARD CHESKY, INDONESIA DESK, DEPARTMENT OF STATE; ARTHUR DORNHEIM, CONSULTANT TO THE DEPARTMENT OF STATE; AND MARK JOHNSON, FORMER PETROLEUM ATTACHÉ, AMERICAN EMBASSY, JAKARTA

Mr. HEGINBOTHAM. I will make two points. I was the economic and commercial counselor at the U.S. Embassy in Jakarta from 1971 until mid-1975. That is really the basis of my appearing here this morning, because of my familiarity with the evolution of this case. I am presently the Deputy Assistant Secretary of State for Economic Affairs for the Bureau of East Asian and Pacific Affairs.

INDONESIA PROVIDES CONTRAST

I thought a few points might be worth touching on because Indonesia provides something of a contrast, from some of the other country situations that you may be examining. The differences are fairly sig-

nificant in that Indochina was one of the oil-exporting countries, and its difficulties probably evolved around some unusual circumstances that are probably worth highlighting.

INDONESIAN POLITICAL SITUATION

First of all, the political situation pertaining to Indonesia was one of a rather dramatic turnaround in 1966-67, in which the Sukarno government, which had brought the country to the edge of economic collapse, had been gradually edged out of power. The Suharto government replaced it and began to follow a very responsible, fiscally conservative series of policies which began with rescheduling of the then massive Sukarno government debts, the conclusion of a standby agreement with the IMF, supporting that rescheduling of debts, and a very close working relationship with the World Bank and with a consortium of both creditors and donor countries which strongly supported and favored the return to fiscal and economic rectitude of the new government. On top of that, the Government adopted policies to encourage foreign investment and participation of private capital in the development of the economy. The overall result was a rather dramatic turnaround from a 600-percent annual inflation in 1967-68 to a rather sharp drop in inflation rates to the point where they achieved a less than 10-percent rate of inflation by 1970-71.

The internal politics were extremely interesting because the Government, which as a military-based, military-supported government, turned immediately to a group of foreign trained technocrats primarily with economic credentials, who had no personal power base. At the same time, the President and the Government looked to a medical doctor, Gen. Ibnu Sutowo, to pull together the oil sector, which was obviously a key aspect of the economy. General Ibnu achieved some rather dramatic breakthroughs not only domestically but internationally in the sense that he fathered what has since become pretty much a world standard for contractual arrangements for the exploration and development of oil—the production-sharing contract.

SUCCESS OF TECHNOCRATS

The success of the technocrats on the economic side was matched by the success of General Ibnu in turning the oil situation around from producing 600,000 barrels of oil a day in 1968 to double that figure by 1972. Indonesia had in effect nationalized the oil industry in its entirety and at the same time attracted levels of foreign investment in the oil industry which were unparalleled in Indonesia's history and in fact in Asia's history. So, it was an interesting irony that the act of nationalization was followed by very substantial foreign private investments in the oil sector.

In the process of doing this, General Ibnu demonstrated a degree of pragmatism, of reliability in contractual arrangements, and a judgment which gained for him the respect and confidence of President Suharto, and the international oil and banking communities. As a result, a great number of projects were assigned to him to accomplish. General Ibnu had acquired by this time a considerable inter-

national status and had ready access to heads of government in a variety of major industrial countries.

INDONESIA PRESSED FOR REVENUE

It is also worth a footnote that Indonesia at this time was extremely hard pressed for revenues. It had adopted a rather unique system whereby the armed forces carry on a variety of commercial enterprises by which they support their own military costs, so that the central government budget was relatively lightly burdened by military expenditures. It was not at all unusual for a military man to be running a state enterprise such as General Ibnu did.

So, as a result you have the anomaly of a two-track development system. You have the technocrats running the economy overall and General Ibnu running the oil sector, which was, of course, the most important one in terms of Indonesia's foreign exchange earnings.

GENERAL IBNU'S STYLE

The styles, as you might imagine, were quite dramatically different. Ibnu relied on very rapid decisionmaking, and on his personal contacts with international financial and government officials. He moved quickly. He put projects into being rapidly and got a rapid payback, generally in self-liquidating activities.

TECHNOCRATS' STYLE

The technocrats by contrast developed a very complex array of arrangements with donor governments and international donor institutions, which required many studies, slow, painful processes, with each donor having a different set of procedures. So understandably the whole process was much slower, and in some cases much more uncertain.

The result was, you had two tracks, both running directly to President Suharto, with rather minimal coordination, if any, between the two at times. Also there were data and management deficiencies which further complicated the process of coordination once it was later attempted. There was, in fact, competition between these two tracks. Gradually, over time, General Ibnu was given more and more project responsibilities.

INDONESIA'S OPEC MEMBERSHIP

I will pass over the next section on Indonesia's OPEC membership by just commenting that Indonesia has been an OPEC member but with a very appreciable distinction. It was a very small potato in the overall organization, accounting for only about 4 percent of OPEC's overall oil production in 1972.

Further, it was not a price leader. It was a silent partner attending the meetings more to monitor its own interests in the oil sector than to participate. It did not participate in the Arab oil embargo, and in fact all during the embargo it became an increasingly important

supplier to the United States. Eventually as natural gas and other oil reserves were discovered and developed, it became apparent that the United States could look to Indonesia as an increasingly important and dependable supplier in a world where there were rather great uncertainties about some other sources of oil supplies.

Indonesia is also an OPEC member with a difference in the sense that its oil exports do not remotely cover its development needs so that Indonesia remains a very poor country—less than \$200 per capita. Its oil earnings on a per capita basis are minimal, \$25 per capita whereas in the Arab oil countries, the levels are in the tens of thousands of dollars per capita.

THE FINANCIAL EXPERIENCE OF INDONESIA

The financial experience of Indonesia and Pertamina are segmented in my outline into roughly four phases. The first one really begins about 1971 when the process of restoring the pieces of the oil industry have pretty well advanced in Indonesia and Ibnu was beginning to be assigned a number of development projects. Since the Government did not have adequate funds, it was the tendency of the President to turn to General Ibnu, in whom he had great confidence, and say, General, here is an important project, we would like you to get it done, and nobody discussed where the money was to come from.

So, the general felt that he was under a responsibility to obtain funding for these projects from whatever sources were available to him. The ambitions of the President and the Government to get the economy back on the track were considerable and rather quickly the amount of Pertamina's borrowing became an issue in the country and in the Government. As a result, there was a flurry of activity involving the IMF and the Indonesian Government around the question of what the proper limits should be for Government and specifically Pertamina borrowing abroad.

A SERIES OF STANDBYS

There were a series of standbys beginning in 1968, in which the Indonesian Government proposed overall borrowing limits which the IMF accepted as reasonable. There were eventually discoveries that some of these borrowing limits were being exceeded by Pertamina in its eagerness to get on with its projects. The effort to tighten the borrowing practice intensified in mid-1973. Actually, there had been earlier instances, but it became particularly critical as the amounts rose.

The technocrats tried increasingly to take steps to gain some degree of influence over the borrowing practices of Pertamina. At the same time, among the commercial banks there were a variety of contenders for Pertamina's financial attentions. Some of the early loans appeared to be particularly unfavorable to Pertamina. Some of the resident and United States and European banks there tried to provide refinancing and new financing on longer terms, or better terms, for the Pertamina projects.

It was in October of 1973 that the first major oil price increase took place. This in turn whetted perceptions of what Indonesia and Per-

tamina might accomplish, and I think it gave additional impetus to the notion that Pertamina could carry on perhaps an even wider variety of projects in the future.

DIFFICULTIES BEGIN IN 1974

Serious difficulties began to occur in 1974, a phase that I refer to as "the unraveling", when international money markets tightened. I will have to reconstruct here from a very interpretive recollection. You had the first oil price increases in late 1973. You then had the mounting deficits of various countries, beginning in late 1973, early 1974. The oil countries were just beginning to accumulate excess reserves, so if my recollection is correct by early 1974 you had not seen the recycling effects beginning, so that you did not as yet have the experience of the banks being awash with liquidity as they later were, once the recycling process and the Arab funds began to flow into the banking system.

There was some tightening at that period, and Pertamina began to have difficulty borrowing medium term. It had previously devised a special means of getting projects started without the assurance of long-term financing that the IMF and the Indonesian Government desired: it had begun to borrow short term funds. Now it was having difficulty rolling over the short-term funds.

Of course at the same time the bankers were becoming increasingly concerned about the total volumes of Pertamina's borrowing.

The various regulatory agencies were also becoming concerned about the quality of bank lending, so the difficulty of sustaining the short-term borrowing program increased.

Mr. LEVINSON. Do you mean by regulatory agencies U.S. regulatory agencies?

Mr. HEGINBOTHAM. Yes; U.S. regulatory agencies. I cannot speak to what was going on elsewhere, if anything. The first signs of a severe immediate problem began to appear in February of 1975, when Pertamina failed to get some credits in the Middle East that it hoped would tide it over its liquidity problems.

THE CRISIS COMES TO A HEAD

The crisis came to a head in mid-February of that year. At that point I think that the nature of the problem that had developed became fully evident to President Suharto. He made a series of very firm decisions which involved the Central Bank's assuring that Pertamina's obligations would be met on a current basis, and so far as they were found to be legitimate, the Government then provided funds to meet a series of short-term obligations that were coming due.

THE REVIEW OF PERTAMINA'S ACTIVITIES

At the same time, the Government appointed the Minister of State for Administrative Reform to review the entire gamut of Pertamina activities. As a result of this review a number were eliminated, cut back, or shifted to other government agencies. A number of major contracts were renegotiated, and the Government then with the help of a

number of very substantial responsible international investment banks did some refinancing and some new financing to pay off the short-term debts. Over the period 1975 to 1977 it has restored a fiscal profile, and—although I cannot speak for them officially—I believe the IMF and the IBRD are now satisfied that the situation is in hand. The achievement of this has been carried out in a very professional and satisfactory way. The debt burden that Indonesia now faces, which will peak in 1978–80, can be managed, and the crisis situation is over.

I have supplemented the outline that I sent to you yesterday with some comments on my interpretation of commercial bank perspectives and IMF objectives. I will pass over the IMF objectives, because I think they are well enough known as a general matter.

PERTAMINA'S MANDATE

The commercial bank perspectives, again, this is purely my own interpretation—began with the sense that Pertamina clearly had a presidential mandate to carry out a wide range of economic activities, and that it was an organization that had positive net earnings. I am now going back to about 1971. It had positive net earnings, and furthermore, it supervised and controlled the receipt of oil tax payments and the production of Indonesia's most bankable asset. In addition, it was so pivotal and so crucial that the banks did not see any way that the Government could afford to let Pertamina's debts not be met.

THE BANKS' BELIEF OF THEIR ROLE

In addition, there were banks that clearly believed that they could play a useful role in bringing Pertamina to more responsible financial operations and that they could improve the quality of its borrowing and the methods and procedures involved in its borrowing, and they did in fact encourage Pertamina to take important steps in that direction. It is difficult to pinpoint a time at which the banks themselves, including the most responsible of them, became convinced that the situation had reached a dangerous stage, but clearly they did, at some point in the 1973 time frame. We then found cooperation increasing gradually between the banks and the IMF and the Government of Indonesia authorities, that is, the technocrats.

GENERAL IBNU AN INTERNATIONAL GLAMOR STOCK

The only parting comment I would also make is that the international participation in the funding of Pertamina was truly that. I think it is fair to say that General Ibnu was clearly an international glamor stock in his early days. The appeal that his operations had to an immense diversity of interests was very great. Lined up at his door were not only bankers but suppliers and a variety of other nonbank financial institutions.

In the beginning, the quality and type of the institutions loaning to Pertamina were less good than they were. I would say, in the middle period. So it was a very mixed pattern of funding sources that were discussing and negotiating with Pertamina. The U.S. banks were an important but by no means the only ones. There were Japanese and a

wide variety of European institutions also involved. I think I will terminate my remarks at this point.

Senator SARBANES. Thank you. Senator Javits?

IMPLEMENTING CONDITIONALITY

Senator JAVITS. Mr. Heginbotham, let me give you a frame of reference in which I intend to ask questions so this does not hit you out of thin air. We are interested in this committee in examples of countries operating under IMF conditionality and how that works as it relates both to governmental credit and to private credit. That is my first question. In other words, practically, what is the way of implementing conditionality and can it be successfully implemented based upon previous experience?

My second question is this: What is the role of the Department of State in respect of such an operation through its diplomatic agencies in a foreign country where we are involved not in a governmental sense but both in a governmental and a commercial bank sense?

Third, based upon this experience, what do we learn to help us in either legislation or in the way in which we conduct our policy within the IMF and in a diplomatic sense through our embassies?

It is at my personal insistence that you have been called to have the State Department give us the framework of the proposition. I do not mean that I dreamt up this idea. On the contrary, our staff has done an extraordinarily gifted job, but I ask that you be called before others are called who are perhaps with the commercial banks or witnesses from other organizations, because I did feel that we ought to have the framework and the State Department's side of the story and the policy our Government has pursued, is pursuing, and will pursue. That is the whole point of this exercise, as I see it. I wanted to give you that picture. We are not going to spare anybody, I can tell you that in advance, but we are going to proceed, thanks to our chairman, and Senator Sarbanes is sitting in for him very kindly, in a considered way, and with the responsibility which a matter like this requires. Do I make myself clear?

Mr. HEGINBOTHAM. That is fine, sir.

THE ROLE OF THE STATE DEPARTMENT

Senator JAVITS. So, my first question would be this. Tell us, please, what was the State Department's role in respect of this kind of side pocket operation of the particular general, General Ibnu, who had Pertamina under his management and who was asked by the President because he was apparently a guy who could get it done to undertake all of these other projects, including Pertamina, which ran into this brick wall of difficulty.

Also in that connection who did you do business with? Was it Ibnu? Was it the Ministry of Finance which was the official agency? Or how did you find your way between the two? Lastly, what was your relation to the U.S. banks with particular attention to the regional banks as well as the great international banks like Citycorp., which was one of the leaders there?

THE EVOLVING SITUATION

Mr. HEGINBOTHAM. Sir, I will do my best to answer you. The situation, as you can imagine, was an evolving one. In 1971 it was not at all clear how it was going to develop. It was already apparent that, as I mentioned, there were two quite different tracks going on, and they did not relate to each other terribly effectively. As a result, our early activities were primarily involved with monitoring developments closely. It was clearly felt to be in the U.S. national interest to support the technocrats in their activities because this meant the return to responsible economic policies and cooperation with international organizations.

At the same time, the success of their efforts depended quite considerably on the effectiveness of General Ibnu in managing the petroleum sector. The early evidence was that he was doing that extremely well.

We were in the unusual position of being in a country where foreign investor participation had been pretty much liquidated during the Sukarno era.

THE EMBASSY IN UNIQUE POSITION

As a result, the embassy was in a rather unique position of being looked to much more extensively by incoming business and banking officials than is often the case where you have a wide range of choices of banks and others who have been in the country for a long time. As a result, it was not too difficult to discern that there was a developing fever pitch of interest in the banking community in Pertamina's activities and what opportunities it might provide to the banking sector.

It was also quickly known that Pertamina had begun borrowing substantially in Europe from non-U.S. sources and some of the terms were known to be considered by the banking community at that time uncompetitive, that is, unfavorable. Thus the banking community showed an interest not only in the volume potential of Pertamina but also in demonstrating that it could do better than it was doing in terms of borrowing provisions.

THE EMBASSY'S CONCERNS IN 1972

Again, this is hard to reconstruct exactly. Having only been back in the country a day or two, I have not had a chance to review the record as fully as I would like. However, I believe it is fair to say that in early 1972 we began to become quite concerned about the evidences of very substantial Pertamina borrowing and increasingly as 1972 went by we began to advise the banks to be very cautious and very prudent about their behavior with regard to Pertamina because of the great difficulties we found in getting any kind of indication of the volume of the credit that were being acquired.

At the same time, it was quite clear that the IMF was having serious problems in determining the facts. They could not find Indonesian Government officials who were willing to take on inquiring of General Ibnu as to exactly what he was doing. So we began a process of trying to play a neutral role of monitoring as closely as we could all sources of information because there clearly was going to be a major problem.

This meant, in response more specifically to your question, that we maintained very close communications with the banks who came to see us and we went to see them, with the IMF, with whom we maintained extremely close working relationships throughout this period, with the Bank of Indonesia, with the Ministry of Finance, and with the planning ministry. Those were the principal actors on the Indonesian Government side.

THE IMF'S REQUESTS

The situation was sufficiently unclear that there was no way you could cover enough sources of information to feel satisfied that you had done all that needed doing. Let me check my record for a moment for a date. Incidentally, I will add that the IMF, when the occasion arose, made direct requests for assistance to the governments of countries where banking activities appeared to be heavily involving Pertamina, and in a number of instances they received assistance from such governments.

MR. HEGINBOTHAM REQUESTS TO GO OFF THE RECORD

Incidentally, if I may, since I have not had a chance to check the confidentiality of this, I would if I could request that this be kept off the record until I can check it out.

Senator JAVITS. Mr. Heginbotham, we cannot keep anything off the record that is uttered in public session, so do not give us what is confidential. Just tell us if there is information which is confidential, and then if we choose to go into closed session we can get your information, but we cannot assume that anything here is off the record. It is all on the record.

Mr. HEGINBOTHAM. Well, to generalize a little bit then for that purpose—

Senator JAVITS. We are to assume then that you will be giving us information which will omit certain confidential information, and we can decide if we want to hear you in closed session?

NO EXCHANGES BETWEEN IMF AND GOVERNMENTS

Mr. HEGINBOTHAM. That is correct, Senator. There were contracts and exchanges of information between the IMF and governments whose banks were involved, in order to assist in clarifying the position of the borrowing levels engaged in by Pertamina. From these contacts it became clear that some of the ceilings imposed by the Indonesian Government were being exceeded.

Senator JAVITS. Some of the ceilings imposed by or on?

Mr. HEGINBOTHAM. Imposed by the Indonesian Government. In other words, these were ceilings proposed by the Indonesian Government which the IMF accepted as appropriate to the situation, and found them acceptable for purposes of renewing the standby arrangement.

THE FIRST IMF STANDBY

Mr. LEVINSON. If I could fill out the picture that Senator Javits started to draw, when was the first IMF standby approximately?

Mr. HEGINBOTHAM. The first was in 1968. This was followed by others. The renewal I mentioned above was agreed in March 1972.

Mr. LEVINSON. Thank you. Without detailing the specific numbers, that standby set certain parameters of external borrowing. Isn't that correct?

Mr. HEGINBOTHAM. That is correct. If you will permit me, as I understand it there is a nicety in the relationship between the IMF and the host government in which the host government proposes ceilings and the IMF either accepts or considers them not acceptable for purposes of renewal.

Mr. LEVINSON. Thank you.

EXCESSIVE BORROWING NOTED BY IMF

Mr. HEGINBOTHAM. This excessive borrowing was notified by the IMF to the donor countries at the IGGI meeting in early 1973. That is the Inter-Governmental Group for Indonesia which is a consortium of the donor countries which were assisting Indonesia, including the IBRD and the ADB. At the same time, the U.S. Government was concerned that the donor governments whose banks were participating in these excessive borrowings, in these borrowings beyond the ceiling, should be aware of the seriousness with which we considered these ceiling breaches.

OUR CONCERN ABOUT BORROWING

We therefore indicated at the IGGI meeting our own concern about these borrowings and urged the participating governments to support the efforts of the Indonesian Government and of the IMF to maintain these ceilings.

Senator SARBANES. Where was this meeting and who represented us?

Mr. HEGINBOTHAM. The meetings are typically held twice a year, I believe, in May of each year in Europe, in the Netherlands, which has been the chairing country for the IGGI meetings. We are represented normally, I believe, by a Deputy Assistant Secretary of the Treasury, who usually heads the delegation. There are participants from most of the Federal agencies with foreign economic concerns such as Agriculture, State, AID, and Commerce.

Senator SARBANES. Earlier, you kept saying that we were trying to find this out and we were trying to find that out. Are you talking about the Embassy officials?

Mr. HEGINBOTHAM. Yes; this was the Embassy, in order to keep Washington informed as well. Mr. Dornheim reminds me that we also made direct representations to U.S. banks encouraging them to cooperate fully with the Indonesian Government in attempting to maintain ceilings which were acceptable to the donor community and in line with what we felt were responsible policies.

Senator JAVITS. Those representations to U.S. banks were made where, in Indonesia?

Mr. HEGINBOTHAM. They definitely were made in Indonesia, in a couple of instances when senior officials from U.S. banks came to Indonesia to pursue negotiations.

Senator JAVITS. What about here?

Mr. HEGINBOTHAM. They were also made in Washington. I believe, at least on one occasion, if my memory serves me, that it was in Washington.

Senator JAVITS. What about the actual communication to the banks where the headquarters were?

Mr. HEGINBOTHAM. This was a communication in which Washington contacted the New York bank office.

Senator JAVITS. And on occasion the State Department went to them, and on occasion they came to the State Department?

RENEWING THE STANDBY

Mr. HEGINBOTHAM. That is right. Following the expiration of the 1972 standby agreement, the Fund then reviewed with the Indonesian Government and with the donor countries the situation and further consultations were held between the IMF and the Indonesian Government. A standby was renewed for the following year with increased ceilings but in this case a very unusual subceiling specific to Pertamina borrowing was incorporated. These ceilings were set to cover a range of medium- and long-term borrowing in the range between 1 and 15 years.

THE PURPOSE OF THE LIMITS

The purposes for these limits were twofold: one, to permit Pertamina, if it could to acquire very long-term concessional financing in the 15-year period and beyond. The IMF did not nor did the government see the need to set ceilings on the long end of the spectrum. By the same token, at the short end of the spectrum the intent was to leave flexibility for working capital financing. This is again my interpretation.

After a period of some 2 or 3 months had elapsed, we began—again, by we I mean the Embassy—as well as the IMF, and the Indonesian Government, began to get wind of rather large short-term borrowings which appeared out of line with the working capital needs of the enterprise. Again, I think this was a period when there was considerable cooperation between the IMF and various governments in trying to ascertain what the situation was.

The governments, I would underline, had a very direct interest in this because they were making large concessional aid contributions to Indonesia each year, and they had good reason not to want to see these long-term concessional loans undermined by short-term borrowing which would mortgage the future revenues of Indonesia and raise the possibility of a need for further debt rescheduling.

EMBASSY MAINTAINS ACTIVE CONTACT

As 1973 and early 1974 progressed, we maintained extremely active contact with the IMF, with the Indonesian Government authorities, and there was a balancing process that went on. By this time oil prices had quintupled and there were, we felt, honest grounds for discussion and differences on the appropriateness of the ceilings which had been set up in a period where oil prices were still rising.

It was during this period that we hoped that the Government, and Pertamina in particular, could be induced to shift from general funding borrowing, that is, nonproject specific borrowing, to project-specific borrowing, so that the Government could then assess whether these projects were going to be self-liquidating, whether they met an Indonesian Government priority, a developmental priority, and whether under those circumstances they would warrant some flexibility in the ceiling arrangements.

At that same time, and this was the period of the embargo, it became clear that the United States had a special interest in Indonesia and that Japan did as well, because it became an increasingly important supplier of energy resources for the Pacific Basin when the boycott was continuing. The result was that there were certain projects that took on a particular significance as well—I think there are two that came to the fore early on.

INDONESIA'S BALANCING ACT

The first that I will mention, although not the first in sequence, was the Cilacap refinery. This was important because it permitted Indonesia to refine an increased volume of Middle East crude which it imported and which, in turn, permitted it to export its own crude, which was a more salable product. So, there was a balancing act. Although an exporter Indonesia imported crude for its own purposes which it refined and used domestically. Its own higher quality crude earned a much greater premium through exportation than through refinement for domestic uses. So, that project was important in liberating additional oil exports from Indonesia as its production grew.

Secondly, Indonesia was discovered to have what was at that time two of the largest natural gas discoveries. At this point it was unclear from where the U.S. west coast was going to get its next gas. It was really running into a rather critical shortage, and it was exploring every possibility available. Over a relatively short period a project was developed for the liquefaction and export of natural gas from Sumatra to the west coast of the United States—and to Japan—and this matter is still in its final stages of resolution, as it happens, in the U.S. governmental works at the moment.

In any event, these two projects became subjects for discussion between the Indonesian Government, the IMF, the U.S. Government, the Japanese Government, and others, to consider how these projects might be melded in with responsible policies and the credit ceiling arrangement. In a period of about 2 or 3 months, as I recall it, an agreement was reached under which these projects were considered to be compatible with the IMF-accepted ceilings.

In addition, the World Bank offered to provide experts to assess individual projects to see if they could be financed with a mix of commercial and concessional financing, to give greater flexibility to the ceiling provisions that had been established.

I am sorry to go on overlong in answer to your question, but as you can see there was quite a complex mix of activities going on which required a lot of balancing. I think it illustrates that there was a very close and continuing working relationship going on and at the same

time a certain amount of pulling and hauling in terms of the relationship between the technocrats and Pertamina.

WHO WERE THE TECHNOCRATS?

Senator JAVITS. Technocrats, meaning the Ministry of Finance?

Mr. HEGINBOTHAM. Meaning a team of about five or six economic ministers, including finance, mines, planning, and the central bank. In this period, interestingly, Pertamina itself acquired the services of a major U.S. computer firm, of a major U.S. accounting firm, and a major U.S. investment banking house, all intended to help improve Pertamina's accounting, financial management, and in fact looking to an international bond flotation by Pertamina.

This was a slow and painful process. No one could see how quickly these management improvements would be achieved or whether they would be quick enough to provide the basis for a sounder standby renewal on the next anniversary date. But in any event they were something of a sign of encouragement to those of us who were watching and hoping for improved coordination in financial management by Pertamina.

PERTAMINA'S LIQUIDITY DIFFICULTIES

The problem as I illustrated earlier began to come to a head with Pertamina's liquidity difficulties. It was borrowing short for long term projects and found it was simply unable to roll these over. At this point in 1975, Pertamina failed to remit to the Indonesian Government two payments, two quarterly payments for which it normally served as a conduit in channeling Indonesia's share of the oil companies earnings to the Indonesian Government. These retentions were designed to help it through its liquidity crisis, while Pertamina sought some Arab country financing. Since it did not succeed in getting this financing, it found that the tax retentions were not going to get it through and in January of 1975, the defaults occurred. At this point we were maintaining very close touch with Pertamina, with the Government, with the International Monetary Fund and with the other donor countries, and the Government decided to take things in hand not only in terms of taking any further access to international money markets from Pertamina but also of standing behind the obligations that were falling due.

THE EMBASSY'S ROLE

At this point, the Embassy served the role of encouraging moderation because we felt that the Indonesian Government had the situation under control and that IMF cooperation was adequate to meet the situation. We tried to play the role of encouraging some coolness at this point on the part of the banks so that they would not panic and call a default which would, in turn, have caused all of the cross-default provisions of the whole structure of debts to collapse at the very moment when it seemed the Government finally had the situation in hand.

These were extremely tense and difficult days over a period of about 2 weeks. There were, I think, on some of the regional banks, some supervisory pressures or scrutiny which was making their directors

nervous and therefore there was some inclination on the part of one or two banks to call a halt at that point.

CALLING A HALT

Mr. LEVINSON. By calling a halt, do you mean to demand payment, to declare a default?

Mr. HEGINBOTHAM. More than a technical default. Now, here I am in trouble because I do not understand enough about the technicalities of banking. As I understand it, there were a couple of credits which were in, I guess you would put this in quotation marks, "technical default," which did not precipitate any action by any banks. How you define the next stage in which they simply call for full payment, I do not know.

Senator JAVITS. That is the terms of the loan. In other words, they have to require payment.

Mr. HEGINBOTHAM. Yes, they had the option, I guess, of either extending or calling for full payment. They did not call for payment because I believe everyone concluded objectively that the authorities had the situation in hand and were moving quickly.

WHAT WAS THE ROLE OF THE EMBASSY?

Senator JAVITS. At that point, what was the role of the Department? Let's understand each other, because you are speaking a little obliquely.

The fact is that the banks made loans to Pertamina which were skimming the IMF conditionality either in amount or due date or both. Now, what was the role of the State Department at the time of the crunch, which came in early 1975, with the banks, with IMF, and with the Indonesian Government specifically?

Mr. HEGINBOTHAM. I have not reflected the preceding activity in which we were consistently encouraging the banks to exercise restraint and to cooperate fully with the Indonesian Government. We found that that was not the case in a variety of instances, but we did not find any authority for going beyond the advisory and cautionary role with respect to the banks at that time. At the point, then, of the technical defaults—and incidentally, I cannot speak for the activity of the Federal Reserve Board and the Comptroller of the Treasury, because—

Senator JAVITS. Comptroller of the Currency?

Mr. HEGINBOTHAM. Yes, Comptroller of the Currency—because we did not have an adequate view from Jakarta as to what was being done back here. I think it is correct—I do not have data really at hand and I am not sure I could even develop it—but I think the great majority of these short-term credits were financed out of Europe. Now, through what institutions and to what extent the U.S. banks were indirectly involved, I just do not know.

Mr. LEVINSON. Those were Eurocurrency credits, weren't they?

Mr. HEGINBOTHAM. Those were Eurocurrency credits, yes, sir. I will also say that there were individual American banks which, while present with resident officers in Jakarta, did not at any time participate, so there was a very mixed picture of bank activity. At the time of the technical defaults, we were very active in trying to keep communications open between all parties and trying to encourage responsible

actions on the parts of all concerned, and particularly to support the efforts of the Indonesian Government to get a handle on the situation.

DECISIONS OF THE INDONESIAN GOVERNMENT

At one point, the Indonesian Government, the Central Bank, made a series of decisions with regard to insisting that Pertamina not engage in any further world money market activities, and indicated that the bank would not guarantee—and here the wording is important—would not guarantee Pertamina's debts because they did not want to put themselves in that position, but they wanted to assure that Pertamina's obligations would be met, a subtle difference which meant that the bank worked directly with Pertamina to make sure that it had the funds to meet its obligations as they were found to be legitimate.

Now, for reasons of their own, the Central Bank officials did not want to put out a public statement to that effect. I cannot comment on the reason for that, but it then became a little nerve-wracking for us, because we could not get an official statement from the Bank of Indonesia, but we felt it was important to reassure the banks that there was a commitment of the Indonesian Government behind the Pertamina obligations. So we requested authority from the Central Bank to state on behalf of the Central Bank, as an official position of the Central Bank, these decisions which we communicated orally to the individual banks. I believe we were also given permission to communicate them in writing to the banks.

This was an intermediation which was informal but which calmed the situation at that time. At that point, then, everyone drew back, and the situation from that point progressively was unwound as the Government reviewed the obligations and paid them off. There was a brief period in which, again, since there were only two or three people in the whole Bank of Indonesia who dealt with these problems, since they had ballooned and fell upon them suddenly, there were some delays in the bank's assessing and meeting these payments. I think in September there were two or three payments which again fell overdue and were in technical default but were purely the result of administrative factors.

So, again, the Embassy attempted to ascertain that that was in fact the case, and to dispel any rumors that the Government was not going to meet its obligations.

THE AMOUNT OF INDEBTEDNESS INVOLVED

Senator CASE. Mr. Chairman, may I ask for some information as to the amount of indebtedness that was involved here?

Mr. HEGINBOTHAM. I am not sure that the books have ever been closed on this, Senator, but the amounts that we were aware of at that time, as I recall, were in the vicinity of \$2 billion.

Senator CASE. \$2 billion?

Mr. HEGINBOTHAM. Yes.

Senator CASE. Short term?

Mr. HEGINBOTHAM. No, a mix of short term and long term.

Senator CASE. How much was short-term bank loans?

Mr. HEGINBOTHAM. May I give a figure and then correct that?

Senator CASE. Sure.

Mr. HEGINBOTHAM. My recollection is that it was on the order of half a billion of short term. Just to put that in perspective, Indonesia's gross oil earnings at that point were on the order of \$4 or \$5 billion. Let me check that, please.

[Pause.]

Mr. HEGINBOTHAM. I am told that the short term was actually closer to \$1 or \$1½ billion, but we will check that figure.

Senator CASE. The short term is closer to \$1 or \$1½ billion out of a total of how much?

Mr. HEGINBOTHAM. I am sorry. I was really off on the figures. About approximately \$6½ billion was the total depending on what were defined as liabilities. This is a total which it has taken about 2 years to finally ascertain.

Senator SARBANES. Was this the total that Pertamina had incurred, \$6½ billion?

Mr. HEGINBOTHAM. That was the ultimate figure.

Senator SARBANES. Of that, \$1½ billion was short term?

Mr. HEGINBOTHAM. That is my understanding.

A LOOPHOLE VIOLATION

Senator CASE. And that short term debt had been created, the banks had lent the money, in effect in violation of IMF terms and conditions, and in excess of what the IMF thought was reasonable to the extent of \$1½ billion?

Mr. HEGINBOTHAM. Again, technically, anything less than 365-day credit was not covered by the ceiling, so that this was a violation, if you will, of the spirit but not of the letter of the ceiling. There was a loophole in effect.

Senator JAVITS. A violation in effect because it was understood that it would continue to be rolled over?

Mr. HEGINBOTHAM. That is correct.

Senator JAVITS. In other words, it could be 364 days and on the 365th day they would roll it over?

Mr. LEVINSON. Senator Case and Senator Javits, if I might, wasn't there also the technique of a 15-year loan which would fall within the IMF ceiling but on which 90 percent was repayable within 5 to 10 years, so again that was technically within the terms, but not consistent with the spirit? That is a fair statement, isn't it?

Mr. HEGINBOTHAM. I have heard that technique was used. I have never seen any actual loan documents.

Mr. LEVINSON. Of the \$6½ billion, approximately \$3.3 billion was in tanker loans from private banks for Pertamina's famous tanker projects?

Senator SARBANES. I think at this point we had better recess briefly to respond to this rollcall vote. This is the Brooke amendment.

WHAT WILL WE DO ABOUT THESE SITUATIONS?

Senator JAVITS. Mr. Chairman, may I first put a question of record before we go? I would like the witness to think about it. Now, I have

not really taken the time that you have on this, and it is very necessary that we get this in perspective. I think the key thing is, what have we learned and what are we going to do about it? We are here considering the Witteveen Facility, which is an IMF facility as a backup for this kind of proposition. That is what I would hope you would think over while we go and vote.

[Whereupon, a brief recess was taken.]

Senator SARBANES. The subcommittee will come back into session. Mr. Heginbotham, did you want to elaborate further on the answers you were giving before we recessed?

CLEARING UP THE FIGURES

Mr. HEGINBOTHAM. Thank you, Mr. Chairman. I would like to do that, because I think the figures may not have been sufficiently clear. The figure of \$6.5 billion includes \$3.3 billion, to the best of our immediate data, of time charter commitments on tankers which leaves a figure of \$3.2 billion of other debts, of which, and I cannot be sure of the figure, but of which the short-term indebtedness was somewhere between 1 and 1.5 billion. We will have to provide that for the record to the best of our ability to reconstruct it.

Senator SARBANES. Could you develop a fact sheet on the amount of the debt and its composition and submit that to the subcommittee? I think it would be helpful to have that.

Mr. HEGINBOTHAM. We would be pleased to do that.

[See appendix.]

IDENTIFICATION OF MESSRS. DORNHEIM AND CHESKY

Senator SARBANES. Would your two colleagues at the table please identify themselves? I don't think that has been done.

Mr. DORNHEIM. I am Arthur Dornheim, a retired Foreign Service officer. I served on the Indonesian desk between October 1973 and August 1977.

Mr. CHESKY. I am Edward Chesky, the Economic desk officer for Indonesia at the present time, with the Department of State.

DEBTS ARE NOT JUST BANK DEBTS

Mr. HEGINBOTHAM. I have one further point of clarification if I may, Mr. Chairman. These debts are not just bank debts. They include supplier credits and commitments to a variety of entities which are not banks. Whether we can unravel the proportions there I am not sure, but again we will try from the evidence available to see whether we can give you some idea of the proportions of bank and nonbank obligations. That is as much as I can provide at this point. Thank you, Mr. Chairman.

ROLE OF PERTAMINA IN INDONESIAN ECONOMY

Senator SARBANES. That is helpful. Thank you. Let me go back to sort of the basic role of Pertamina in the functioning of the Indonesian economy. It essentially was a State-owned petroleum company, but it operated, as it were, independently of the government.

Mr. HEGINBOTHAM. It operated, as best we could ascertain, under the direct authority of the President. That is to say that General Ibnu reported and consulted directly with President Suharto on the major decisions affecting the corporation. There was also a direct linkage between Pertamina and the Department of Mines. That relationship had varying dimensions from time to time. I would not be a good witness on that subject. We have our petroleum officer from Jakarta who is here and who might speak to that relationship.

I did not work intimately with that relationship, and I could not really spell out how those two entities related. I can say, however, that about the middle of this period a board of commissioners was revitalized which included the Minister of Mines, the Minister of Finance, the head of Pertamina, and possibly I think there was one other commissioner on that board which met periodically. It had made decisions on specific overall aspects of Pertamina policy. It was not our feeling that that was a terribly effective mechanism for most of this period. It quite apparently did not succeed in acquiring control over the financial decisions of the corporation.

WHAT WERE BANKS RELYING ON FOR REPAYMENT?

Senator SARBANES. When a bank considered making loans to Pertamina upon what would the bank be relying for the repayment of the loans?

Mr. HEGINBOTHAM. I can cite an example of a situation in which a bank had a contractual credit to Pertamina in which the contract, as I am told—I did not see the contract—indicated that this contract had the approval of the Government of Indonesia. At this point you then get into an interpretation of what is the Government of Indonesia.

Senator SARBANES. Are you citing me an incident that is atypical or is that typical?

Mr. HEGINBOTHAM. This is an example of a contract that occurred once the banks became aware of the seriousness with which the Government considered it.

Senator SARBANES. Then this came later on?

Mr. HEGINBOTHAM. It was sort of midterm.

GOVERNMENT OF INDONESIA STANDS BEHIND PERTAMINA

Senator SARBANES. It was when the Government of Indonesia, given the situation in which Pertamina found itself, sort of moved in, in effect to sort of stand behind Pertamina in order to avoid defaults. Is that correct?

Mr. HEGINBOTHAM. Not to avoid defaults, but in order to gain an influence over the borrowing decisions of the corporation.

Senator SARBANES. Wasn't it also to forestall the lenders from placing Pertamina in default?

Mr. HEGINBOTHAM. This was before the default question arose. The Government, in its decree implementing control regulations, specified that loans should have the approval of the Indonesian Government authorities and the Ministry of Finance specifically. We never were able to get access to loan documents to the extent that we could tell to what extent those regulations were in fact followed by either the banks or the nonbanking institutions.

ARRANGEMENTS BETWEEN PERTAMINA & FOREIGN COMPANIES

Senator SARBANES. Were the oil production arrangements between Pertamina and foreign companies?

Mr. HEGINBOTHAM. That is correct.

Senator SARBANES. Not between the Government and the companies?

Mr. HEGINBOTHAM. If I am not mistaken, those were directly between Pertamina and the oil companies.

Mr. CHESKY. [Nods affirmatively.]

Senator SARBANES. To whom did the oil companies make their payments in terms of the financial arrangements which had been made, which was their recompense?

Mr. HEGINBOTHAM. It is my understanding that there were two arrangements in effect. There was an older generation of contracts, the so-called contract of work.

Senator SARBANES. Would the person at the left identify himself?

IDENTIFICATION OF MR. MARK JOHNSON

Mr. HEGINBOTHAM. I am sorry, Mr. Chairman. This is Mr. Mark Johnson, who has been the petroleum officer in the Embassy of Jakarta. He has just returned from Jakarta and is much more intimately familiar than I with the specific arrangements.

Senator SARBANES. Would you like to defer to him for this particular question?

Mr. HEGINBOTHAM. Fine.

TWO FORMS OF CONTRACTS IN INDONESIA

Mr. JOHNSON. As Mr. Heginbotham said, there were two forms of contracts operative in Indonesia. First and oldest was a contract of work, a semiconcessional arrangement that was negotiated in 1963. Under this arrangement, the proceeds were split on a cash basis, 65 percent for the Government of Indonesia and 35 percent for the company. In this case, the newer generation, the production-sharing system was introduced in the late 1960's. This featured not a split of cash but a split of crude. There were varying arrangements. The first form was 65-35 percent, 65 percent going through Pertamina, eventually, part of that destined for the Government. Thirty-five percent was for the company.

There was also a feature for cost recovery. Companies could take a certain amount of cost in kind in crude on an annual basis.

Senator SARBANES. I am still not clear as to where the people lending to Pertamina will be looking in order to recover on their loans. Did Pertamina in effect keep these proceeds or was it obliged to pay them over to the Government of Indonesia or pay a portion of them and have the balance on which to repay?

PERTAMINA AS THE COLLECTING AGENCY

Mr. JOHNSON. Well, each contract was slightly different, but in effect Pertamina served as the collecting agency. It was obliged to pass through a certain percentage of the revenues or crude that it got from

the companies to the government. The net effect was that Pertamina kept as retained earnings something like 10 to 15 percent. I cannot be more precise than that, because as each new generation of contracts was developed, the percentage changed, but in theory there was a pass-through mechanism whereby Pertamina collected on behalf of the Government of Indonesia from the companies.

WHAT ARE WE DOING NOW?

Senator JAVITS. So that I might finish my aspect of the questioning, would you answer the question that I put to you when I left, please? If we are going to depend on conditionality and conditionality is going to be subject to what happened in this situation, obviously there are too many holes in the bottom of the sack. So as I know our governmental authorities have applied themselves to that situation, I would like to know what are we doing now? What are we going to do to avoid this kind of thing happening?

Mr. HEGINBOTHAM. Senator, with every respect, I will be happy to interpret from my observation of the Indonesia experience insofar as that seems contributive. I would just mention that Under Secretary Cooper and Mr. Hormats will be appearing and will be addressing these questions with the broader perspective which is appropriate. I would like to make my principal contribution in that respect by working directly with them, and contributing to their judgments on this. I do in fact work very closely with them.

I would hazard a couple of observations that I hope will be useful, although they may appear timid to you in the broader context that you have asked.

First of all, I think that I have the very highest regard for the management of the IMF in the situation in Indonesia. It was working in an extremely delicate and difficult situation where there are two tracks to the President, as I mentioned, with corresponding delicacy of involvement where there are contending sides.

Senator JAVITS. The President you speak of is the President of that nation?

Mr. HEGINBOTHAM. The President of Indonesia, yes, sir. I think the role of the IMF was an extremely fine and constructive one in that they achieved a degree of coordination and communication with all of the parties in a very even-handed way. They were very candid and direct in their dealings, and I think inspired the confidence of all parties.

Secondly, of course, the Fund has had to deal with a great variety and diversity of countries and country situations, so it would seem to me that one of the fundamentals here is the degree of trust that one feels one can concede to an institution that would be responsible, in this case the IMF. I think I have not heard any criticisms by donor countries or others that the IMF handled the situation in anything but a highly responsible and effective way. It is difficult to foresee and to legislate, I would suspect, all of the contingencies that the IMF is going to have to contend with, and the donors, in dealing with governments and banking communities.

SPECIAL SITUATIONS IN INDONESIA

Beyond this, there were special situations in Indonesia in that, and I believe this comes back to the chairman's question, in effect you had an unusual situation in which, if I could interpret for the banks, they were counting on the fact that Pertamina was sitting on top of the country's greatest asset and was in effect managing not only its production but also the revenues that flowed from it. And in this sense, they considered the interests of the Government and of Pertamina so coincident that they considered this for practical purposes a sovereign risk kind of lending in which the balance sheet was perhaps less important than the fact that you had confidence that the Government was going to stand behind the obligations.

Whether that confidence was well placed or misplaced I will have to leave to the committee to judge. I think this does make the Indonesian situation somewhat different in the sense that many of the other countries where the lending is proceeding do not involve banking on an asset, as I think was the case basically in Indonesia. I hope you will forgive me for those limited comments, but that is about as far as I feel I can stretch the interpretation at this time.

SENATOR JAVITS SUGGESTIONS

Senator JAVITS. I think that is fair. Mr. Chairman, I am through with this witness. I would suggest and request that the staff communicate with the Comptroller of the Currency, with the Federal Deposit Insurance Corporation, and with such other authorities as relate to our private banking system that we have a claim on in order to see how they proposed to handle the U.S. commercial bank relationship with the IMF in the use of the Witteveen facility and other IMF lending, taking this as a case history in which obviously we do not know what the coordination was, but we should know what it was and what it will be.

I think that will complete the picture, as far as I can see.

Mr. LEVINSON. We will do that, Senator.

THE BALANCE OF DEBT

Mr. HEGINBOTHAM. Mr. Chairman, may I supplement one comment which does bear on your last point? Senator Javits, before you returned I was clarifying some statistics on the balance of debt. I pointed out that there is a considerable volume of this debt that emerged from nonbank sources, so one is dealing not only with banking sources but with suppliers who arrange their own credits, and a variety of, if you will, circumventions that were possible, so I think the data on this will be instructive because I think it is fair to say that it is simply not limited to a commercial bank problem here in that sense.

Senator JAVITS. Well, I agree with you, except that commercial banking is the big one, and we will at least deal with that. Then we will assume that we will call the Treasury respecting the IMF arrangements. You have already told us that Dick Cooper will appear. In that way we will have the complete picture. If you can think of any-

thing else that would give us a more complete picture, please let us know.

Mr. HEGINBOTHAM. I would be happy to, sir.

Senator JAVITS. Thank you, Mr. Chairman.

A TWO-TRACK SYSTEM

Senator SARBANES. As I understand this, in effect there was a two-track system. Pertamina was borrowing, as it were, privately, either from banks or incurring obligations with suppliers.

Mr. HEGINBOTHAM. [Nods affirmatively.]

Senator SARBANES. The Government of Indonesia was borrowing to the extent it was, and following a much more restrained course of borrowing from the international lending institutions.

Mr. HEGINBOTHAM. Yes, and donor countries.

Senator SARBANES. Not privately?

Mr. HEGINBOTHAM. There have been in 1975 and 1976 borrowings from private banking institutions. In this case, the great majority of these were taken to refinance the Pertamina borrowings.

Senator SARBANES. I am talking about the earlier period, as they moved into the situation and as they were moving out.

Mr. HEGINBOTHAM. Now, the only exceptions to those were where commercial banks participated in donor government assisted export credits, such as the Eximbank. There were a couple of Eximbank loans in which commercial banks also participated in the financing of Indonesian Government projects. Those were again somewhat more recent.

THE MIX BETWEEN AMERICAN AND FOREIGN BANKS

Senator SARBANES. Do you have any feeling about what the mix was with respect to private commercial bank lending to Pertamina as between American banks and banks, private banks of other countries?

Mr. HEGINBOTHAM. That would take some real digging, Mr. Chairman, because these fundings were often consortia, and they were often, as Mr. Levinson pointed out, Eurodollar entities, which did some of the lending, and to sort this back to the original institutions would take some time. We could certainly try.

Senator SARBANES. Did there develop a point either at the outset or as things moved along in which the more experienced private commercial bank lenders in effect were not engaging in the lending to Pertamina, and the lead, as it were, in the role was assumed by other banks not ordinarily found in such a role?

THE ROLE OF SMALL REGIONAL BANKS

Mr. HEGINBOTHAM. I think it is fair to say that we saw unusual examples of small regional banks playing a role in syndications. That is not, I am told, usual. This was an aspect of the Pertamina borrowing situation.

Senator SARBANES. You at one point in your testimony earlier in fact said that when this effort was being made, as I understand it, on the part of officials of the Government of Indonesia and officials of the various governments, including ours, to curtail private bank lending

to Pertamina, which was essentially being done, at least in spirit, violating the IMF conditions, and you said when you were talking about the banks which cooperate, you said, including the most responsible of them. So I take it in your own view you make the distinction or a break between the behavior of some banks which you would characterize as responsible and the behavior of others which you would perhaps characterize as irresponsible?

Mr. HEGINBOTHAM. I think we saw a fairly broad spectrum of behavior from those that did not lend at all, to those that lent with an effort to improve the fiscal and financial management of Pertamina, to those that seemed more interested in making a fast loan.

THE IMF CONDITIONS

Senator SARBANES. Now, the IMF conditions which control medium-length borrowing in effect, I take it, two practices developed to continue as it were to get around the conditions. One was to make the 360-day loans and rule them over. Is that correct. And that the volume of that jumped markedly once the IMF conditions were agreed to by the Government? That is, once the Government of Indonesia agreed to certain limitations which the IMF found acceptable?

Mr. HEGINBOTHAM. That is correct.

Senator SARBANES. Also, there was a 15-year limit. Some loans were made outside, say for 15½ years, but concentrating the repayment within the 5- to 10-year period. Is that also correct?

Mr. HEGINBOTHAM. I understand that is the case, yes.

THE EMBASSY'S REACTION

Senator SARBANES. What was the Embassy's reaction to those practices? First of all, did you know about them more or less coincidentally with when it was happening, and what was your reaction to them?

Mr. HEGINBOTHAM. As I indicated, the great majority of the information on these came from European sources, and they seem to have been funded primarily in the Eurodollar market where we did not have direct sources of information. We learned about them gradually, as the cooperating information networks developed, but I cannot think of any instance where we were privy to information in time to discourage this practice in a specific case involving U.S. banks.

Needless to say, I do not think the banks were advertising this technique, and as a result we did not know about it until, I think, almost entirely after the fact.

Senator SARBANES. You mean so much after the fact that the practice was not going on and had pretty well stopped?

Mr. HEGINBOTHAM. We continued throughout this period to attempt to exercise and restrain bank lending within the agreed ceilings. In general terms, how much our comments to banks targeted on those who were doing this practice I have no way of knowing.

CONVERSATIONS WITH BANKS THROUGH STATE DEPARTMENT

Senator SARBANES. You said earlier that you tried to do that, one, by your conversations with representatives of banks in Indonesia, that

there were also communications with the central offices of the banks in this country. Is that right, through the State Department?

Mr. HEGINBOTHAM. Through the State Department, yes, sir.

Senator SARBANES. At whose instance? Was it at our initiative or responding to the initiative of the Government of Indonesia? Perhaps it was responding to the IMF?

Mr. HEGINBOTHAM. My recollection is that this occurred particularly at the time when the United States in the very early stages was concerned about the initial breaches of the standby ceiling which the IMF reported. At that time there was indication that there was a particularly large syndication in progress and in order to forestall any decisions in that syndication that would violate the intentions of the IMF and the Indonesian Government, we suggested from the Embassy that this matter be taken up through Washington with the headquarters of the bank or banks involved.

This was the main instance that stands out in my mind where we knew in advance enough to be able to try to encourage the bank's cooperation. My recollection is that we were also consulting very closely with the IMF at that time and that they were aware we were doing this.

PRIVATE LENDERS CIRCUMVENT IMF CONDITIONS

Senator SARBANES. Now, you had a situation in which the IMF had negotiated the conditions and yet the private lenders were circumventing the conditions and therefore contributing to a more difficult situation in Indonesia.

[Mr. Heginbotham nods affirmatively.]

Senator SARBANES. Now, did you say earlier that most of that circumvention was money coming out of Europe?

Mr. HEGINBOTHAM. Excuse me one moment.

[Pause.]

Mr. HEGINBOTHAM. Particularly this 360-day money, it was my understanding, was coming mainly out of the Eurodollar market. I really could not accurately tell you what the balance of these global figures that I gave you was in terms of Eurodollars, but my impression is Eurodollar sourcing was usually the principal marketing origin of these funds.

Senator SARBANES. Of course, those could have been American bank branches in Europe.

Mr. HEGINBOTHAM. That is correct.

Senator SARBANES. Do you know if they were?

Mr. HEGINBOTHAM. I am sorry, Senator. Without really digging back, I just could not tell you for sure.

CROSS-DEFAULT PROVISIONS

Senator SARBANES. You have made reference earlier to the cross-default provisions of these various loans. Would you explain that, please?

Mr. HEGINBOTHAM. As a layman I will do my best. It is my understanding that most if not all of the commercial bank loans included what is referred to as a cross-default provision. This means that, if any loan which falls within the reach of other loans having cross-

default provisions, should go into default, those other loans with cross-default provisions would also be in default, and payable upon demand. This is a device whereby a bank, even though its own loan is not in default, could protect itself in case other loans fell into default. This means that you have a whole structure of loans relating to each other, and if anyone went into default, it is possible for all of the creditors to call their loans on demand.

Again, we never had access to loan documents other than maybe in one or two random instances. As a result, I cannot tell you what percentage of these loans had such provisions or whether, for example, supplier credits had similar provisions. I just don't know.

Senator SARBANES. Now, in this very critical 2-week period to which you earlier referred, was the fact that the various contracts had cross default provisions heightening of the situation?

Mr. HEGINBOTHAM. Yes, sir, it was. It did heighten the situation.

Senator SARBANES. The Embassy's efforts during that period were directed to seeking to preclude any of the lenders from in effect calling a default, were they not?

INDONESIAN GOVERNMENT TAKES STEPS TO RECTIFY SITUATION

Mr. HEGINBOTHAM. Based on our judgment, Mr. Chairman, that the Indonesian Government had taken or was in the process of taking all of the steps that would be necessary to rectify the situation and to eliminate the technical defaults, and based on our appreciation that the IMF also agreed with that assessment, we felt it was our responsibility at that point to try to prevent precipitous action by U.S. banks at the very time that the resolution of the problem appeared in hand. We had no rulebook to go by, and it was a question of our judgment of the circumstances.

So, we did in fact encourage the banks to remain calm and not to trigger defaults which could have defeated the Indonesian Government's efforts to rectify the problem.

Senator SARBANES. Were you in the position of having to make that argument to all of the banks or did some of the banks perceive that to be in their own self-interest and therefore not have to be argued with, and did you really then have to deal with only one or two?

Mr. HEGINBOTHAM. Forgive me. I neglected that point. In a number of cases these loans were consortium loans and there was a consortium leader or leaders who similarly acted to keep members of the consortium from triggering any collapse of a particular consortium, to keep the consortium together. I think the principal uneasiness came in connection with some of the regional banks whose role was unusual, being involved in syndications. Again, I am told this. I am not an expert in this. The regulatory agencies had caused them to be nervous about their positions, and so their nervousness about Pertamina in turn was increased by the sense that they might be having problems back home. This is my interpretation.

A SMALL BANK COULD CALL DEFAULT

Senator SARBANES. Let me ask you two questions to follow this up. First of all, a bank that would have a relatively minor part of the

syndication would still be in a position to call a default. Is that correct?

Mr. HEGINBOTHAM. That is my understanding, sir.

Senator SARBANES. It could have just a few million dollars in terms of the total debt picture that we are talking about here and yet be in a position to call default on the syndicate's loan. Is that correct?

Mr. HEGINBOTHAM. That is correct.

Senator SARBANES. Then the cross default provisions that apparently prevailed through all loans would have come into effect?

Mr. HEGINBOTHAM. That is correct. Please let me clarify two points in that respect. That would put them into technical default and there would still be the discretionary judgment of other banks whether they would in fact call the loan. In addition, there are restraining forces on any one individual bank in that it is a member of a syndicate. I would assume there are obviously pressures from other banks for it to stay in the syndicate as long as the conditions looked to justify that.

A POSSIBLE COLLAPSE OF THE HOUSE OF CARDS

Senator SARBANES. Well, I can understand that, but the leverage at work here enables a very small lender who either panics or for other good reasons decides that he just does not want to carry this on to call a default. That means that the syndicate in its entirety is in effect calling a default. Then the cross default provisions come in and the whole house of cards comes tumbling down.

Mr. HEGINBOTHAM. I would appreciate it, Mr. Chairman, if you would pursue that question more with the banking authorities than with me. Unfortunately, I am not an expert. Having never even examined a loan contract, I am on tenuous ground here.

Senator SARBANES. Well, now, you are inclined not to get the banks to call default, given what the situation was. Is that correct?

Mr. HEGINBOTHAM. That is correct.

Senator SARBANES. There were regulatory authorities here with respect to the bank lending practices that were raising apparently serious questions as to the bank's portfolio, in effect putting a counter-pressure on. Is that correct?

Mr. HEGINBOTHAM. That is correct.

COMMUNICATIONS BETWEEN STATE DEPARTMENT AND BANK REGULATORY AUTHORITIES

Senator SARBANES. Did the Department of State communicate with the bank regulatory authorities here in order to diminish that pressure?

Mr. HEGINBOTHAM. We did not attempt to communicate to influence their decisions in any way. What we did do was to communicate factual developments which we felt they should know, which would be material in their making any judgments. For example, at this rather tense period when things were moving very rapidly in mid-February of 1975, we communicated immediately when the Indonesian Government made its decisions to stand behind Pertamina's obligation, so the Federal Reserve Board and the Comptroller of the Treasury should be

as immediately aware as possible of the Indonesian Government decisions.

For that reason, we wanted to be sure that decisions were not made out of phase with developments in Jakarta, so our main function was simply to keep them fully advised. I think that during that period and earlier we were routinely designating our telegraphic traffic to be passed to the Fed and to the Treasury for that purpose, so that they were kept fully informed.

Senator SARBANES. Did you indicate to the banks that you were doing this? I mean, did the banks understand that you were seeking to lessen or diminish the pressure they were feeling from the regulatory authorities given the situation that existed and your encouraging them to withhold from declaring default?

Mr. HEGINBOTHAM. We felt that relationships with the Federal Reserve and with the Treasury, which are highly independent in their banking examination activities, were purely confidential U.S. internal matters and we were simply providing them an information channel for that action. We did not discuss that with the bank at all, nor was this information intended, as I say, to affect the decisionmaking other than to provide them with the facts so that they would not be out of phase with the developments.

Senator SARBANES. Was the communication with the banks on the question of the default in Indonesia or did it also take place back here by the State Department to the home offices of the bank or banks involved?

Mr. HEGINBOTHAM. I am sorry, communications with whom? Would you repeat your question, please?

EMBASSY URGES BANKS NOT TO DECLARE DEFAULT

Senator SARBANES. You were urging the banks not to declare default. Is that correct?

Mr. HEGINBOTHAM. At that point, yes.

Senator SARBANES. Where did that urging take place?

Mr. HEGINBOTHAM. In Jakarta.

Senator SARBANES. Did it take place back here as well?

Mr. HEGINBOTHAM. Excuse me a moment.

[Pause.]

Mr. HEGINBOTHAM. The only thing that took place here was to relay to the bank headquarters the assurances of the Indonesian Bank, the Bank of Indonesia, of its intent to stand behind the obligations coming due so that the bank headquarters here were fully and immediately informed. Not all of the banks engaged in lending to Pertamina were represented in Jakarta, and therefore some of this information was transmitted through Washington.

Senator SARBANES. Let's get a more graphic description of this. You had representatives of the banks out at Jakarta. I take it you would meet with them at the Embassy and say, you know, we think this thing is being worked out. We do not want you to declare a default. Is that correct?

Mr. HEGINBOTHAM. It was actually a little easier than that, because it happened that General Ibnu had invited a group of 24 foreign

bankers to Indonesia and they were all there at that specific moment, and so it was relatively easy to communicate with the bankers at that point. There were a few exceptions where we communicated through Washington.

DISCUSSIONS WITH BANKERS

Senator SARBANES. Did you call them into the Embassy and have a general meeting where you communicated with them or did you discuss this with them individually?

Mr. HEGINBOTHAM. I discussed this individually with each banker.

WHAT COMMUNICATIONS WERE SENT HERE?

Senator SARBANES. What communications were sent back to this country and what communications took place here? You said that you informed the banks. I take it that you sent cables to the Department and the Department then met with the representatives of the banks.

Mr. HEGINBOTHAM. I would like to ask Mr. Dornheim, who I believe was here at that point, to comment on that, because I could not from my vantage point.

Mr. DORNHEIM. We had a cable sent on March 9, 1975, and it arrived on the 10th, and on that day I called by telephone about seven or eight bank headquarters, ranging from San Francisco to New York. I conveyed the information which was given to Mr. Heginbotham orally by the Governor of the Bank of Indonesia saying that they were going to meet, and while not guaranteeing the debts, they were going to say that there would be sufficient money in Pertamina's accounts to repay the short-term loans as they fell due, and that all future borrowing for Pertamina would be done by the government. That was passed directly to the seven or eight bank headquarters, the major ones.

Senator SARBANES. Were these banks not represented in Indonesia?

Mr. DORNHEIM. Some were represented in Indonesia. Some may not have been. I am not certain.

Senator SARBANES. Were they the only American banks that were involved in loans to Pertamina?

Mr. DORNHEIM. By no means. A lot of the banks were very small participants.

THE FOCUS OF NERVOUSNESS

Mr. HEGINBOTHAM. I might clarify, Mr. Chairman, that the concern really focused on two or three banks, or on syndicate leaders where the loans were due at that point. That was really where the focus of nervousness was.

Senator SARBANES. Who were those leaders? Do you know?

Mr. HEGINBOTHAM. I wonder if I could provide that to you in writing for the record.

[The material is in subcommittee's files.]

Senator SARBANES. Were the terms that the banks obtained when they circumvented the IMF restrictions by either the 360-day rollover or the 15½-year loans with heavily weighted early payment particularly advantageous to them?

Mr. HEGINBOTHAM. Let me understand the question. Were the terms of these 360-day loans particularly advantageous to the banks?

Senator SARBANES. Yes.

Mr. HEGINBOTHAM. I am not aware that the bank terms were out of line with commercial practices at that time. I think the advantage was simply that of volume. It permitted the banks to conduct credit activities with Pertamina which otherwise would have been precluded presumably by the limits.

THE BANKS WILLINGNESS TO LEND

Senator SARBANES. Did any banks ever indicate to you when you were urging them not to engage in these loan practices and the possible dangers of them that they really saw no danger because in the end they assumed that the Government of Indonesia would in fact stand behind the loans; that our country and other countries could not really permit the default to take place. Therefore, while you were telling them that they were engaged in a risky enterprise and so forth, they really saw that no matter how they went into the matter in the end they would be held harmless?

Mr. HEGINBOTHAM. I think that probably underlay a good deal of willingness of the banks to lend. Some of them made greater efforts than others to ascertain the underlying situation of the corporation. There were a number who were engaged quite deeply in trying to get a proper balance sheet. Also at this time, as I mentioned, there were a number of internationally outstanding firms that were working with Pertamina to assist it in improving its financial management. So I think that some of it was also a degree of confidence that with this external assistance and with the evidence they saw of Pertamina making an effort to improve its financial management, they could gradually come to rely more on the balance sheet of the corporation and less on their instinct that the debts ultimately would not be defaulted.

But it is difficult to assess how they balanced these considerations.

Senator SARBANES. I was not clear on one answer you gave, and that was the question of whether the bank representatives to whom you were talking in Indonesia were led to understand that the Department was intervening with the bank regulatory agencies here to diminish the pressure they were placing upon the banks with respect to their loans.

THE FUNCTION OF THE EMBASSY

Mr. HEGINBOTHAM. I would like to make very clear that we did not at any time discuss our relationships or our communications with the Federal Reserve or the Treasury, nor did we in any way attempt to diminish any pressures that they might have been exerting on the banks. Our function was an information function of making sure that they were fully informed and up to date on decisions being taken by the Indonesian authorities.

Senator SARBANES. I understand how you are characterizing, what you are doing, but that was not the question I asked. The question was whether the bank representatives knew or understood that you were doing something even if we accept for the purpose of this question the characterization that it was simply for informational purposes.

Mr. HEGINBOTHAM. They were not informed or in any way led to believe by the Embassy that we were communicating with these authorities.

PERTAMINA SITUATION DURING OIL EMBARGO

Senator SARBANES. Do you know whether Pertamina considered, given its financial problems, undercutting the OPEC price in order to sell more oil and therefore obtain greater revenues to relieve its difficult financial situation?

Mr. HEGINBOTHAM. In late 1974, Pertamina had difficulty marketing some of its oil. The marketing difficulties arose as I recall in the initial instance because Japan had acquired very large quantities and its storage facilities were full. It later became clear that two particular grades of Indonesian crude were disadvantaged by the uniform price arrangements and as a result Indonesia introduced differential pricing of those two crudes. This was not an unusual practice in the sense that there was a good deal of differentiating going on in prices. You had a marker standard in the Middle East, but there were differentiations from those in the Middle East also, so I don't believe that there was any inference that Pertamina was undercutting the OPEC price at that time.

There was a later instance, however, in which Indonesia did not follow fully one of the later OPEC price increases. This was when the two-tier split developed, and they stayed on the low side of the split.

DID WE INFLUENCE PERTAMINA?

Senator SARBANES. Were we, the Embassy, involved in trying to influence the Pertamina pricing policies in those circumstances?

Mr. HEGINBOTHAM. If you will permit me, I will have to check with my colleagues, because I do not recall.

[Pause.]

Mr. HEGINBOTHAM. Subject to double-checking the record, Mr. Chairman, my recollection is that we did make a demarche at the very beginning and that at the time the very first cartel price increase was made, there was a global effort to attempt to get restraint by OPEC as a whole. That is the one instance that I can specifically cite.

Senator SARBANES. OK, Mr. Heginbotham, we thank you very much. It has been a very interesting morning. We thank your colleagues. This committee will now adjourn.

Mr. HEGINBOTHAM. Mr. Chairman, might I just add, and this is meant sincerely that I was particularly impressed by the very excellent staff study which your staff executed. I think it was a very fine job.

Senator SARBANES. Thank you very much. This committee is adjourned.

[Whereupon, the subcommittee was recessed, to reconvene at 10 a.m. on Friday, October 7, 1977.]

EXPORT-IMPORT BANK DEBT REPAYMENT PROBLEM FACING THE GOVERNMENT OF ZAIRE

FRIDAY, OCTOBER 7, 1977

UNITED STATES SENATE,
SUBCOMMITTEE ON FOREIGN ECONOMIC POLICY
OF THE COMMITTEE ON FOREIGN RELATIONS,
Washington, D.C.

The subcommittee met at 10:10 a.m., pursuant to call, in room 4221, Dirksen Senate Office Building, Hon. Frank Church (chairman of the subcommittee) presiding.

Present: Senators Church and Clark.

Also present: Jerome Levinson, chief counsel.

Senator CHURCH. Our witness this morning is John L. Moore, the president and Chairman of the Export-Import Bank of the United States.

Mr. Moore, we are very pleased that you are a witness this morning. You have a prepared statement to present. I invite you to proceed with that statement and then we will ask you questions.

STATEMENT OF JOHN L. MOORE, JR., PRESIDENT AND CHAIRMAN, EXPORT-IMPORT BANK OF THE UNITED STATES

Mr. MOORE. Thank you, Mr. Chairman.

May I introduce Charles E. Gaba from the legal staff of the Bank and John Lentz, a loan officer, both of whom are working in Zaire.

DEBT PROBLEMS OF DEVELOPING COUNTRIES

Mr. Chairman, I appreciate your invitation to appear today to discuss certain aspects of the debt problems facing many developing countries. It is my understanding that in this connection you wish to examine with us mechanisms currently in place to deal with debt repayment problems and most particularly the debt repayment problem facing the Government of Zaire.

THE SITUATION IN ZAIRE

Although Zaire began this decade with the ability to attract significant sums from international lenders and investors, the country's difficulties during the past 3 years have created a situation where new funds from either source have almost dried up. The result has been a major credit problem for public and private lending institutions.

Zaire's current situation may be traced to a sharp expansion in its external debt which rose from about \$300 million at the end of 1970 to

\$1.9 billion on December 31, 1976. By the second half of 1975 Zaire was finding it increasingly difficult to meet its payments on these obligations. Copper, the country's primary source of foreign exchange, had fallen in price to about one-third of its April 1974 peak of \$1.50 per pound. This situation was exacerbated by the short- and medium-term structure of Zaire's debt which called for heavy repayments during this period.

In late 1975 the Government requested assistance from the International Monetary Fund, and by March 1976, Zaire had developed a stabilization program that was the basis for IMF authorization of drawings on a first credit tranche and on other IMF facilities totaling \$150 million. The stabilization program included a pledge by Zaire to seek relief from its heavy debt burden.

THE PARIS CLUB

Accordingly, those public institutions which had direct loan or guarantee exposure, and are known collectively in this case as the Paris Club, convened in mid-1976 to consider rescheduling certain maturities of medium- and long-term debt. This rescheduling was initiated by the Paris Club members on June 16, 1976. It called for unpaid principal and interest due between January 1, 1975, and June 30, 1976, plus principal due between July 1, 1976, and December 31, 1976, to be repaid over a 9-year period beginning on July 1, 1977. The interest rate was left for bilateral negotiation between Zaire and each creditor government. The overall U.S. rate was 7.8 percent which included a rate of 8.375 percent on Eximbank's rescheduled exposure. This is our standard rate for credits with a 9-year maturity.

THE \$200 MILLION DEBT RELIEF

Unfortunately, the estimated \$200 million of debt relief provided by this rescheduling did not prove sufficient. Throughout 1976 copper prices continued at depressed levels, and late that year Zaire approached the IMF for higher credit tranche drawings. In April 1977, new IMF credit totaling \$85 million was granted, but on the basis of a tightened program involving restrictions on the Government, quarterly targets for certain key variables, and a review mechanism. This program was based on the assumption, as was the case in 1976, that Zaire's creditors would grant certain debt relief. The Paris Club was reconvened and on July 7, 1977, initiated a rescheduling similar to that of the previous year. Details on both reschedulings are attached to my statement as an appendix.

THE LONDON CLUB OR PRIVATE LENDERS

During this period the United States, as well as other members of the Paris Club, have placed emphasis on comparability of treatment between public and private lenders. The private lenders to Zaire have formed a "London Club" and are in the advanced stages of considering how they might best address the problem—either through an offer of new credit or by debt rescheduling. It is expected that a formal London Club proposal will be presented to Zaire in the near future, following which the Paris Club governments will have to determine

whether such offer represents reasonable burden sharing between public and private lenders. We believe that the terms of any private offer to Zaire do not need to be identical with the Paris Club reschedulings, but must constitute a significant commitment which will result in equitable burden sharing.

Generally speaking, Eximbank strongly supports the use of creditor club arrangements, such as the Paris Club, when a debtor country has defaulted on its debt service or is about to reach that point. We believe that the creditor club offers the best available means of providing needed support for individual countries in such a position, leads to equal treatment among lenders, brings cooperation and order to difficult situations, and results, ultimately, in a greater likelihood of repayment. These advantages are further enhanced when the arrangements can be related to an IMF stabilization program designed to improve the country's financial position.

EFFECT OF THE RESCHEDULINGS

The reschedulings that have been proposed to date by the Paris Club have been acceptable to the participants and generally have accomplished the basic purpose of the rescheduling. Further, the matter of comparability of debt relief treatment is usually addressed in a Paris Club multilateral agreement by the inclusion in the agreement of a nondiscrimination clause in which the debtor pledges to seek similar relief from creditor countries not participating in the Paris Club and other nongovernment creditors holding similar types of debt.

Some developing countries view their debt service obligations as an impediment to growth and would like to have their payments rescheduled or forgiven. Reschedulings in these cases would not be a matter of financial necessity, however, and would actually be a form of development assistance. Eximbank does not believe that debt rescheduling is appropriate in these circumstances and supports convening a creditor club only when it is clear that a country cannot service its debts.

EXIMBANK'S EXPERIENCE IN ZAIRE

Let me now turn from the general to the specific and discuss Eximbank's recent experience in Zaire. Our exposure on August 31, 1977, was \$435.3 million. Roughly 70 percent of this total, \$307 million, is represented by exposure on a single project, the Inga-Shaba electric power transmission line. Other significant cases include jet aircraft on which we have a \$44.4 million exposure and the first Paris Club debt rescheduling which involves an exposure of \$27.1 million. Eximbank's exposure on the second rescheduling, estimated at \$26.8 million, has not yet been segregated from the individual credits or guarantees.

THE INGA-SHABA LINE

The most troublesome of these cases has been the Inga-Shaba transmission line—a 1,100 mile d.c. line designed to carry power from the Inga hydroelectric site near the Atlantic Ocean to the copperbelt in Shaba province. In November 1973, Eximbank approved financing support for this project consisting of direct credit and guarantees on private credits totaling \$238.5 million.

EXPOSURE OF REPAYMENT

Because of worldwide inflationary trends it was apparent by mid-1975 that there would be a substantial cost overrun on the project. In December of that year, Eximbank received an application to finance \$68.5 million of additional U.S. costs. This case posed a dilemma for the Bank. On the one hand, we and the private lenders had disbursed virtually all of the original financing, leaving us with a large exposure the repayment of which could have been in jeopardy if the project were not completed. On the other hand, Zaire's external finances were coming under increasing pressure and payments due external creditors, including Eximbank, were many months in arrears.

Our initial position was to continue support for the project as we remained convinced of the importance of providing additional power to the Shaba copperbelt which could result in expanded copper sales and foreign exchange earnings. We did, however, establish a condition that Zaire set up an external account into which foreign exchange sufficient to meet Eximbank's direct and guaranteed debt service on the project would be paid by the Government's copper marketing agency. Such payments were to be made on a monthly basis and directly after receipt of funds by the agency from the purchasers of Zaire's copper. It was on this basis that Eximbank, following the required review of this case by the Congress, authorized the additional \$68.5 million of loan and guarantee financing for the project on April 6, 1976.

THE CONCERN OF U.S. COMMERCIAL BANKS

By mid-1976 it became clear that certain U.S. commercial banks were concerned that Eximbank, through the above arrangement, might obtain a prior secured position for its Inga-Shaba exposure to the detriment of their existing credits. Notwithstanding lengthy discussions, two institutions, Citibank and Banker's Trust Company, felt so strongly about the matter that they filed suit against Eximbank in August 1976, alleging inducement to breach of contract by Eximbank resulting in deprivation of their property—in this case a contractual right—without due process of law.

ZAIRE INSISTS ON SETTLEMENT OF DIFFERENCES

While we believed that these actions could be successfully defended, they did cause the Government of Zaire to request a settlement of these differences before it would conclude the underlying agreements. Fortunately for all concerned, a settlement was reached that permitted the suits to be withdrawn, and all agreements were signed in October.

The settlement centered on a redefinition of the payment arrangement to apply to all additional Eximbank direct or guaranteed credits rather than the original approach that included amounts already outstanding. I am pleased to report that the revised arrangement has functioned as planned and that Eximbank and its guaranteed lenders are current on the debt service due on our \$68.5 million of supplemental financing for the project.

This special payment arrangement with Zaire represented our response to a most difficult credit and project problem and it should not be considered as a general Eximbank method of securing our transac-

tions in developing countries. We will continue to analyze each case individually and to seek solutions which we believe will be effective in the particular situation.

RECENT PAYMENT EXPERIENCE WITH ZAIRE

Our recent payment experience with Zaire has been mixed. As noted above, we are current on our supplemental financing for the Inga-Shaba project and we did receive the initial July 1, 1977, payment on the 1975-1976 rescheduling. Subsequent to August 10, 1977, however, substantial amounts of interest due Eximbank and its guaranteed lenders have fallen due. Unpaid interest and fees currently total \$10.3 million. Until these amounts are received, we have suspended all project disbursements and have so advised Zaire. We are hopeful that these payments will be made in the near future.

1978 WILL BE DIFFICULT FOR ZAIRE

We believe that 1978 will also be a difficult year for Zaire's economy. Copper prices show no sign of recovery from their present levels and the country's debt burden, including a large accumulation of arrearages to lenders and suppliers, will continue to be a factor reducing foreign exchange available for other needs. Nonetheless, this vast nation has substantial agricultural, energy, and mineral resources that will be developed over time. To permit that development to occur in an orderly manner, the country will have to exercise great care in assuming additional debt so that its external accounts may be brought into balance and confidence restored.

Mr. Chairman, I would be pleased to answer any questions the committee may have.

[The appendix to the statement follows:]

ZAIRE-PARIS CLUB RESCHEDULINGS—SUMMARY OF TERMS

	1975-76 rescheduling	1977 rescheduling
Date of Paris Club Agreement.....	June 16, 1976.....	July 7, 1977.....
Type of debt covered.....	Medium and long term.....	Medium and long term.....
Maturities rescheduled.....	Unpaid principal and interest due from Jan. 1, 1975, through June 30, 1976, and principal due from July 1, 1976, through Dec. 31, 1976.....	Unpaid principal and interest due from Jan. 1, 1977, through June 30, 1977 and principal due from July 1, 1977, through Dec. 31, 1977.....
Estimated Paris Club exposure covered.....	\$200,000,000.....	\$180,000,000.....
U.S. exposure covered.....	\$39,000,000.....	\$50,100,000.....
Eximbank exposure covered.....	\$27,100,000.....	\$26,800,000.....
Rescheduling period:		
(a) 15-percent initial payment.....	2 annual installments due July 1, 1977, and July 1, 1978.....	3 annual installments due July 1, 1978, July 1, 1979, and July 1, 1980.....
(b) 85-percent subsequent payment.....	1975 exposure repaid in 14 semiannual installments beginning Jan. 1, 1978. 1976 exposure repaid in 14 semiannual installments beginning Jan. 1, 1979.....	12 semiannual installments beginning Jan. 1, 1981.....
Overall term from date of Paris Club agreement through last installment.....	9 yr.....	9 yr.....
Interest rate:		
(a) U.S. overall rate.....	7.800 percent.....	Under discussion.....
(b) Eximbank rate.....	8.375 percent.....	Do.....
Status of United States-Zaire Bilateral Agreement.....	Signed June 17, 1977.....	Draft being prepared for presentation to GOZ.....
Status of rescheduling payments due Eximbank.....	Current—last payment on July 1, 1977, installment of \$5,800,000 received Aug. 5, 1977.....	None due until July 1, 1978.....
Status of commercial bank credits guaranteed by Eximbank.....	Claims totaling \$20,000,000 paid in April 1977.....	No claims received.....

Senator CHURCH. Thank you very much for your testimony.

THE REASONS FOR ZAIRE'S RAPID ACCELERATION

You began your testimony by noting that Zaire's external debt rose sharply in 1970 and 1974. What was the reason for this rapid acceleration?

Mr. MOORE. At that time, as I understand it, since I was not at the Export-Import Bank then, the future of Zaire was considered to be very bright, it was thought to be the Brazil of Africa. There was considerable interest from both government lenders and private banks in investing money in loans in Zaire. It was believed that the vast resources in copper would pay for the development of the country and thus make it extremely credit worthy for lenders. At that time the price of copper rose to \$1.50 a pound.

Senator CHURCH. So that the eagerness of private commercial banks to lend to Zaire was a factor in their general optimistic assessments?

Mr. MOORE. I am sure that must have been a factor.

THE SHORT-TERM STRUCTURES

Senator CHURCH. In your statement, you also note that short- to medium-term structures in Zaire's debt exacerbated the situation. What do you mean by that exactly? You say Zaire was financing long-term projects with sharp medium to long-term loans.

Mr. MOORE. Yes; at least in part. Banks, of course, generally lend their money on up to 5 year terms which we call medium term, so to the extent that Zaire relied on borrowings from private banks they would have been faced with repayments over a period not exceeding 5 years. Our lending, of course, tends to be on a longer term basis for longer lendtime projects—that is, with repayments up to 10 or 12 years after completion of the construction.

HOW DID OIL PRICE HIKE AFFECT ZAIRE?

Senator CHURCH. How did the oil price hike affect Zaire? It went up between 400 and 500 percent.

Mr. MOORE. Mr. Lentz tells me that Zaire has oil of its own offshore on which its income about offsets its own oil costs so it was not that significant a factor in Zaire's case.

Mr. LEVINSON. It is the general recession induced by the oil price increase which impacted upon the price of copper in terms of the reduction of economic activity in the industrialized countries rather than the direct effect, is that correct?

Mr. MOORE. I believe that is an accurate statement.

RESCHEDULING ZAIRE'S DEBT IN 1978

Senator CHURCH. Now Zaire's debts were rescheduled in 1976 and again in 1977 and from what you say about current copper prices I would have to judge that you are going to need to go back to Paris and reschedule again in 1978, is that not correct?

Mr. MOORE. That is correct. We anticipate being called to Paris in late 1977 to discuss that.

WHY ANNUAL RESCHEDULING

Senator CHURCH. What is the point of rescheduling only 1 year at a time? Why don't you reschedule for 2 or 3 years? It would reduce the cost of air fare to Paris among other things.

Mr. MOORE. It has not been that way. If you read the history, it tends to be done for a year at a time. I suppose it is the reluctance of lenders to reschedule debt in the hope that the economy will turn around and it won't be necessary to reschedule the whole debt on such a long term.

Senator CHURCH. Is this annual rescheduling a way to keep the pressure on Zaire to shape up its finances, keep abreast of its repayments?

Mr. MOORE. I think that is true. We feel that other pressures are in order at all times and we have urged them to pay us promptly.

ZAIRE AGAIN IN ARREARS

Senator CHURCH. In Zaire's case though the process is failing in that, as you have testified, Zaire is again in arrears in its interest payments to the Eximbank, isn't that correct?

Mr. MOORE. Well, it will vary from time to time. We did receive payments due in July and early August in the approximate amount of \$5 million which brought Zaire current in its obligations to that time and enabled them to make a further drawing on their Inga-Shaba powerline credit of about \$10 million. Since that time they have not made the required payments, as I noted in my statement.

Senator CHURCH. And currently Zaire is in arrears to your bank?

Mr. MOORE. That is right.

Senator CHURCH. To your knowledge are other governments being paid on time by Zaire?

Mr. MOORE. I think this situation is similar to ours; I think they are not. My impression is that we have received as much payment as have other governments and possibly more since we perhaps are maybe one of the only ones still disbursing and therefore have an additional lever.

DOES ZAIRE OWE OTHERS?

Senator CHURCH. Is Zaire also in arrears on loans from other U.S. Government agencies?

Mr. MOORE. I believe they are—on Public Law 480 and the Defense Department debt. I think that the total amounts that we speak of here are about 70 percent of the U.S. Government debt in Zaire.

Senator CHURCH. They are in arrears on Public Law 480 loans and also on military sales loans?

Mr. MOORE. That is correct.

Mr. LEVINSON. Perhaps you want to get a full picture from AID and other agencies in terms of how much is owing and how much is in arrears.

Senator CHURCH. Yes, I think that would do it.

As I understand it, Zaire also owes an estimated \$400 million in unguaranteed loans to foreign private banks. Has Zaire also defaulted on its private bank loans?

Mr. MOORE. I believe they are in default on obligations to repay principal but are roughly up to date on interest payments. The prin-

cial payments have not been paid to the private banks but are being paid by Zaire into a blocked account at the Bank for International Settlements and I think they are reasonably current on those payments, too.

Senator CHURCH. Would that be kind of an escrow account?

Mr. MOORE. Like an escrow although I understand that the Government's Central Bank of Zaire can draw those funds for any purpose. They have agreed with the lenders to leave the funds there but as far as their relations to the Bank of International Settlements, they can draw them out. So it is not exactly in escrow, Mr. Chairman.

THE COMMERCIAL BANKS ARE IN BETTER SHAPE

Senator CHURCH. I gather then that currently at least the commercial banks have had the interest paid on their loans to Zaire and the principal is being paid into an account so that they are relatively in better shape than you are, wouldn't you agree?

Mr. MOORE. I think that at the present time they are in better shape because Zaire has been in default to us since August 10.

Mr. LEVINSON. Perhaps you could tell us what the conditions are on the part of the banks, the principal that is owed to the Bank of India, to settlements.

Mr. MOORE. The condition is that the \$250 million additional credit discussed at the London Club meetings will have been arranged satisfactorily to the Government of Zaire. That \$250 million financing has not yet been arranged.

Senator CHURCH. Where is that to come from?

Mr. MOORE. It is to be raised by subscription from the private banking sources.

Senator CHURCH. You mean they are now in the position where they have to raise \$250 million more to the satisfaction of the Government of Zaire before they can obtain the money that Zaire owes them on previous loans?

Mr. MOORE. Right. I understand that to be a condition under the tentative arrangements arrived at in the London Club.

Senator CHURCH. Well, isn't that a situation where the debtor country has the creditors over the barrel? I mean it seems to me—

Mr. MOORE. Well, in a sense.

Senator CHURCH. Creditor companies raise an additional \$250 million from a special account or get money that is due them on previous loans.

Mr. MOORE. Yes, but it derived from the result of the Paris Club meetings where the official lenders agreed to a rescheduling of a portion of their debt only on the understanding that comparable treatment would be accorded by the other creditors. The London Club then convened to discuss some arrangement comparable with the Paris Club, and they suggested an additional credit which was not too different from the amount they were to be repaid by the time they were going to raise the additional credit.

THE PARIS CLUB AND THE LONDON CLUB

Senator CHURCH. I see. I am intrigued with the Paris Club and the London Club. The Paris Club consists of the lenders in the public

sector and the London Club consists of lenders in the private sector.

Mr. MOORE. Right.

Senator CHURCH. Now when you meet in Paris to decide to reschedule, which is simply a way to accommodate the borrower, and you condition that upon a comparable arrangement being made between Zaire and the members of the London Club, how can you assure yourself that the commercial banks will agree to comparability?

Mr. MOORE. Well, it is another factor involved in the decision to reschedule 1 year to which you alluded earlier, at a time and the implication is that at the next reschedulings if there has not been comparable rescheduling or refinancing afforded the other debt then the Paris Club will probably require such arrangements to be concluded before a rescheduling is concluded for the subsequent year. We don't have any direct relations with the private lenders, we have it only with the Government of Zaire, so we have bilateral discussions in the sense that the lender is on the one side and the borrower is on the other at two different places.

Senator CHURCH. I would like to examine the kind of comparability that is actually realized in this case. This special fund has been set up.

I will come back to my questions in a moment. Senator Clark, would you like to ask a question now, please? You ask the questions whenever you wish, please.

THE ANALYSIS OF EXIMBANK

Senator CLARK. I just really had one question in regard to your presentation. I read most of it and so forth. I assume obviously the Eximbank is not a private bank but if I were making a loan from a private bank obviously the bank would be somewhat interested in my managerial ability on my borrowing a lot of money and then my own financial record, my sense of responsibility; in other words, the likelihood of my managing that money in a way in which it could be paid back. Do you make such an analysis in terms of the Eximbank in terms of the government that is borrowing money?

Mr. MOORE. Yes, sir. I cannot speak fully to the procedures of the Eximbank in 1972 and 1973 when these loans were structured but only as I found the situation in the Bank when I came in May of this year and subsequently. We make a very careful analysis of the credit, the borrower, and the experience with repayments of debt.

Senator CLARK. Would that not have been required under the law prior to your coming in?

Mr. MOORE. Yes.

Senator CLARK. What kind of analysis do you make? What is your own judgment and analysis of the present government of Zaire and its ability to manage its financial affairs, its ability to repay loans, its soundness, financial record and that kind of thing?

ZAIRE'S ABILITY TO REPAY

Mr. MOORE. Well, they are in an extremely difficult circumstance now with insufficient funds to service their debt as it was originally set up. We hope very much that in cooperation with the International Monetary Fund they will be able to impose the restrictions on their own economy that will be necessary to accomplish this or work out

this difficult situation. That is always hard to do because to cut back on imports means a severe restriction on the standard of living of the people in the country and probably creates additional unemployment and more difficult situations domestically, and that is always a problem. The government does seem to be stable in the sense of being in power for a number of years, and we are very hopeful that they will be able to come through this extraordinarily difficult year.

Senator CLARK. My question was a little different really than the one you answered. My question is, how do you assess the government of Zaire and its ability to deal with these problems based on its financial record and the kind of leadership because it is ruled by an absolute ruler, of course, which is the very stable President Mobutu under a military takeover but is that the kind of government that you feel is going to really repay loans and manage its affairs and has the financial ability and the managerial ability to do that?

Mr. MOORE. This particular one or that structure of government?

Senator CLARK. This particular government.

Mr. MOORE. It is hard for me to answer you, Senator. I have been here and watching them monitoring this situation closely only since May, so I am not sure my experience qualifies me to answer that. Mr. Lentz does point out an additional factor that I didn't mention earlier which is that the IMF conditions require the meeting of management tests which should help.

THE EFFECTS OF A CORRUPT FORM OF GOVERNMENT

Senator CLARK. Yes, that is true. The reason I raised the question, and I will stop at that. I think it is pretty well granted that the government, from top to bottom throughout the structure, is a very corrupt system. People get cut in at almost every level. People in government have their own families and others in charge of most or many of the key financial centers. I am just curious whether those things are taken into consideration in terms of the Eximbank and its willingness to participate and its willingness to become involved and so forth in that kind of an undertaking.

I am just not sure that I agree the IMF agreements of a year ago are going to be helpful and useful. I don't know why they were not required earlier but it seems very difficult to me to view that situation in Zaire given the present government. I assume that all these debts are really going to be paid at some point.

WHAT WOULD BE TAKEN INTO CONSIDERATION NOW

Mr. MOORE. I agree, Senator. I don't have direct knowledge, nor do we at Eximbank, of what you speak. Of course we hear reference to them. If we were in a position of considering a new credit in Zaire, there is no question that we would obtain the best information we could on that kind of subject, and if it were indeed true in our view we would not extend credit in such a situation. Where we are at this point of course, is very different because in order to have credit repayments extended it is a question of arriving at that system which is best designed, in very difficult circumstances, to allow a country

to make some payments, which is the reason for the reschedulings.

Senator CLARK. And you don't know whether that was taken into consideration or not by your predecessor or predecessors?

Mr. MOORE. Oh, I think they were and at that time they must have viewed the situation considerably more favorably than I would be inclined to view it today in reading the newspapers.

Senator CLARK. Thank you, Mr. Chairman.

Senator CHURCH. Certainly, Senator.

A BLEAK FUTURE IN COPPER PRICES

I think most experts see a bleak future in copper prices at least over the next few years. Zaire is competing with other financial countries like Peru for what in actuality is a shrinking copper market, so that being the principal source of foreign exchange for Zaire it is hard to say what the long-term solution to Zaire's debt will possibly be. If we just are rescheduling the debt now and the public sector is involved in it, the private sector is becoming involved although from what I know of the arrangements the preferential treatment has been given to the private sector and I don't see much prospect for getting this problem solved.

Mr. MOORE. I would have to agree that the copper price future is bleak at this point. If the general world recession changes—and that is not going to happen overnight, it will take some years—perhaps the demands for copper will go up. Of course there is a large supply of copper and I cannot say if the world demand goes up that copper prices will rise that much. Certainly it is logical that at some point they would. In addition, they must be very careful in the successful management of allowing Zaire to accomplish a workout.

EQUITABLE BURDEN SHARING

Senator CHURCH. What you are really calling for is a miracle. We are going to have the combined worldwide recovery that will have a highly beneficial impact on copper prices with internal competence of a rare order. I would not want to lay any odds or put any money on the odds that that represents. But you have got a lot of money at stake and you speak of the—what is the term you need, equitable burden sharing. Well, given the arrangement Zaire has made to the commercial banks respecting their loans and the arrangement that has been made with the public sector bank, do you think that equitable burden sharing has been achieved?

Mr. MOORE. Well, first, the arrangement with the private banks has not been finalized which is a disappointment to the official lenders because we would have hoped it would have occurred before now. The official lenders have said the arrangements with the private bank should be comparable, should represent equitable burden sharing. This has been repeated to the Zaire Government whenever we have had the opportunity. The understanding we had was that something roughly comparable would be the arrangement, and it is hard to say until you get back into the Paris Club what all people would regard as roughly comparable but I would certainly think that something on the order

of a 5-year credit with perhaps a 2-year grace period and a repayment over 3 years would be acceptable. That is shorter than what the official lenders have offered, but perhaps something of that nature might be regarded as comparable.

ONE HUNDRED AND EIGHTY-DAY CREDIT

As I understand what the private banks are presently discussing, it amounts to a 5-year credit but there must be repayment of the credit every 180 days which we do not—at least I personally do not—regard as comparable.

Mr. LEVINSON. That is not a 5-year credit.

Mr. MOORE. It does not seem to be.

Mr. LEVINSON. That is a 180-day credit which has to be repaid and if it is not repaid then there is no financing.

Mr. MOORE. I arrive at the same conclusion. There are different arguments made in this approach, but it is not my place to make them. I think Mr. Friedman might give them to you when he testifies.

BURDENS ON THE TAXPAYER

Senator CHURCH. You see, what concerns me and I think other members of this committee is that the Eximbank, the other public sector banks, the IMF, the international agencies operating in the public sector are going to become involved one way or another to a greater and greater degree in leaving out more of its demands so that in the end the burden is shifted on the private banks that made the loans in the first place for profitmaking purposes, and assumed the risk theoretically.

Do the governments that comprise these public sector institutions and through the governments the taxpayer pay? That would be unjust, and indefensible, but it looks to me like we are beginning to move down that path in Zaire and if that becomes a pattern, then we will be going down that path again and again. For example, some of the private bank loans were guaranteed, were they not, by the Export-Import Bank?

Mr. MOORE. That is right.

Senator CHURCH. And when the Government of Zaire defaulted on those loans you had to make good on your guarantees.

Mr. MOORE. On the defaulted installments due prior to 1977, that is correct.

PAYING THE PRIVATE BANKS

Senator CHURCH. Yes. So your guarantees took the risk out of the loans by the private banks and when the defaults occurred you began paying the private banks under the terms of the guarantee and then you had to reschedule those private bank loans with Zaire along with the direct loans we have made to that country, isn't that correct?

Mr. MOORE. That is correct, Mr. Chairman. We considered in our exposure and under our control the guaranteed portion of the loans as well as the portions we have disbursed directly, and the figures I have given in my statement include the guaranteed portions of the loans.

GUARANTEES OF THE U.S. GOVERNMENT

When I spoke of the private bank debt, I spoke only on the unguaranteed private debt. An additional point is that when bankers put out their money against the U.S. Government's guarantee they have an entirely different kind of credit—that is a different kind of expectation and a different kind of return—from what they might have if they were making an unguaranteed private loan to the Government of Zaire.

Senator CHURCH. Well, when you say you have stopped extending further credit to Zaire, do you include in that further guarantees to commercial banks loaning money to Zaire?

Mr. MOORE. Yes, Mr. Chairman.

Senator CHURCH. As well as direct credit?

Mr. MOORE. As a present policy. Now it could be that as a part of rescheduling—although this has not happened before as a part of rescheduling—all of the official lenders might decide to extend some pro rata additional loans. It is not common but I would not want to rule out that possibility if it were discussed. As far as considering new projects now, no, we would not.

EXIMBANK'S POLICY

Senator CHURCH. As far as your own policy is concerned, you are extending no further credit, is that made conditional upon Zaire's continued default? In other words, if the Government were to pay what is now owing the Eximbank, you would then consider changing the policy?

Mr. MOORE. I don't believe so, Mr. Chairman, as far as new projects are concerned until we were satisfied that the management of the Zaire economy turned around. Further disbursements on existing contractual obligations would, of course, be resumed if they brought their debt current.

Senator CHURCH. If this problem can't be solved, is your concept of equitable debt sharing such that the commercial banks would lose on their loans in the same degree that the public sector banks would lose? In other words, equitable debt sharing means that if you both made a bad bargain, extended credit partly on the capacity of a country to repay the country's defaults, then the commercial banks take their share of the loss along with the public sector banks.

Mr. MOORE. I would agree with that. I think the likelihood, based on past experience with reschedulings, is that you don't come to a point in time where you actually have a loss. What you do is a concessional rescheduling over a very long period of time, and I think that the official lenders would do this unless the private banks would share that entire loan on the same basis. We have not been requested to do that.

Senator CHURCH. The concessional reschedulings simply hide the loss?

Mr. MOORE. It does in the sense of the opportunity to relend the money and on a faster repayment schedule. But in most reschedulings we expect to receive interest on a current basis at whatever our current

rates are so it is not concessional as to interest rates in most circumstances and that has been true so far in Zaire.

Senator CHURCH. But it is concessional in terms of the stretchout in the length of time in which the capital itself will be repaid?

RESCHEDULING OF PAYMENTS

Mr. MOORE. So far we have rescheduled payments due in 1976 and 1977 and part of those due in 1975. If we had been paid those installments that have been rescheduled, we could have relent the funds over the 9 years that we have extended them to Zaire. So to that extent you are right. The rescheduling exercise is concessional and that is why the official lenders wanted comparable treatment with the private lenders.

Senator CHURCH. I think that is all the questions that I have.

HOW MANY OTHER COUNTRIES IN SHAKY CONDITION?

Let me ask you this question. How many other countries to which the Eximbank lends large sums of money are in this shaky condition? Is this as shaky a condition now as Zaire or a comparable position?

Mr. MOORE. None other is as shaky as the Zairian situation. There are some other situations right now to which you see reference in the newspapers, such as Turkey and Peru, that are most difficult at this point. They are certainly not in the same position as Zaire and I hope the programs they are working on—such as the IMF—are successful. They have not requested rescheduling, but should they do so, I would expect that the conditions would turn around sooner than the one in Zaire. I cannot say that for certain.

Senator CHURCH. Thank you very much. I have no further questions.

Mr. LEVINSON. May I clear up this point?

Senator CHURCH. Yes.

WHO GETS PAID AND WHO DOES NOT?

Mr. LEVINSON. To just go back to this question of who gets paid and who does not, when you made reference to the fact that there was a suit at Banker's Trust and Citibank against Eximbank because you had the special arrangement on the Inga-Shaba and that they claim that Eximbank was securing a more favorable payment position for itself than the banks have, does it seem to you now that the banks are going one step further and arguing that they should be considered better than official creditors, especially in Zaire?

Mr. MOORE. I am not sure I understand that argument. Are they putting forth that argument?

Mr. LEVINSON. Yes. Essentially they are that in your shopping arrangements you have preferential treatment. Now they seem to be saying that you should accept as comparable this 180-day alleged 5-year payment. I don't know whether you know what front end charges on that are supposed to be. Have you inquired as to what the front end charges are?

Mr. MOORE. We are entitled to know all of the terms when we get the comparison in November.

Mr. LEVINSON. Would you take that into account in determining whether that is comparable and equitable?

Mr. MOORE. Yes. I think we will take all factors into consideration.

Mr. LEVINSON. You would be entitled to ask and you would take that into account?

Mr. MOORE. We would be entitled to ask the Government of Zaire, yes, sir.

Mr. LEVINSON. As part of the out of settlement in connection with the suit against you if one of the banks asked for assurances that the U.S. Government would in effect bail out Zaire if it could not meet its obligation on the part of the banks?

Mr. Gaba may have some knowledge of that.

Mr. MOORE. I understand from Mr. Gaba that that sort of condition was proposed but it was not agreed to.

Mr. LEVINSON. It was not agreed to?

Mr. MOORE. It was not.

Mr. LEVINSON. They did ask for it.

SUPPORT FOR THE PARIS CLUB ARRANGEMENT

Now you said that you strongly support the arrangement such as the Paris Club. Is it fair to sum up the situation so far that under this arrangement what we have got essentially, as you say on page 3, or what has happened is that the governments which have loaned money to share are not getting paid despite generous and repeated scheduling? The IMF provided \$235 million in financial assistance and at this time at least only five of the banks are getting repaid.

Mr. MOORE. The private banks are receiving interest currently and there is a condition on receipt of payments principal.

Mr. LEVINSON. And you have made it known to the private banks you don't consider this equitable burden sharing?

Mr. MOORE. We have said that we didn't regard this as comparable, yes, sir.

Senator CHURCH. Thank you very much for your time.

Mr. MOORE. Thank you.

Senator CHURCH. That concludes the hearing this morning.

[Whereupon, at 11 a.m., the subcommittee adjourned.]

THE WITTEVEEN FACILITY AND THE OPEC FINANCIAL SURPLUSES

MONDAY, OCTOBER 10, 1977

UNITED STATES SENATE,
SUBCOMMITTEE ON FOREIGN ECONOMIC POLICY
OF THE COMMITTEE ON FOREIGN RELATIONS,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:35 p.m. in room 4221 Dirksen Senate Office Building, Hon. Frank Church (chairman of the subcommittee) presiding.

Present: Senators Church, Sarbanes, and Clark.

Senator CHURCH. Mr. Secretary, we have had several previous hearings of the subcommittee on the facility and the testimony that you are presenting today is duplicative of the testimony that we have received heretofore from the Department of State.

I am wondering whether we might incorporate the earlier part of your statement in the record and go directly to the latter part of the statement where you take up the general subject of conditionality, as it would be applied.

Can you find the place in your statement where you can pick up on the general subject?

Mr. COOPER. That is fine with me. It corresponds to my own suggestion. I was going to suggest that I summarize the statement very briefly and then just read the conclusions, but if you would like, I will start a little bit earlier than the conclusions.

I think that by now you will have been given the view that the administration has of the structure of the problem that we are trying to address here and the importance of the supplementary financing facility in doing that.

With your permission, then, I will just read the conclusions, and then go directly to questions. I am at your disposition.¹

Senator CHURCH. If you would do that, I think it would expedite things.

STATEMENT OF HON. RICHARD N. COOPER, UNDER SECRETARY FOR ECONOMIC AFFAIRS, DEPARTMENT OF STATE

Mr. COOPER. It seems to me that there are five broad elements to the approach of the administration to this extremely difficult and complex situation of international payments that we find ourselves in today, and which really is described and analyzed in the first part of my statement.

¹ See p. 169 for Mr. Cooper's prepared statement.

FIVE ELEMENTS TO THE ADMINISTRATION'S APPROACH

First and foremost, we need a steady expansion of the world economy, an objective which serves our domestic aims as well as improving our level of stability. Countries with strong financial positions have a special responsibility in this regard. Countries such as the United States must not run surpluses that add to world adjustment problems under the circumstances in which we find ourselves today.

In the aggregate, the current account deficits in stronger economies are greatly important to the smooth function of the monetary system, insofar as they represent imports other than oil.

Senator CHURCH. At that point, one of these strong economies, usually the German, Japanese, and Americans, are mentioned in that category. What strong economy is operating in a deficit position other than our own?

Mr. COOPER. Of course, by size, the United States is, far and away, the biggest economy. We are now in substantial deficit. After that come Japan and Germany respectively, both of which countries are in surplus. Japan in substantial surplus.

Senator CHURCH. These are the only one of these economies operating according to doctrine?

Mr. COOPER. Of those three. After those three, France and Britain, both of which are in substantial deficit. Italy, and then as you move further down the list, you come across the Netherlands, Switzerland, roughly eighth or tenth and which have surpluses. Of the big three, the United States is the only one running a deficit. Germany and Japan—in using these terms, I am talking now about the current account, not the overall balance of payments position.

WHAT HAPPENS IF NO ONE HEEDS THE DOCTRINE?

Senator CHURCH. What happens to the doctrine, if nobody heeds it?

Mr. COOPER. The most important country is heeding it.

Senator CHURCH. The United States, important as it may be, cannot rectify the problem worldwide without very substantial assistance from other countries.

You are not suggesting that we just shoulder the whole load ourselves, even though the world is off in another direction?

Mr. COOPER. We are not talking about the world; we are talking about two other countries. I am not suggesting or urging—

Senator CHURCH. You are talking about the world, very definitely. The two other countries are the two other major strong economies. They are not conforming to our doctrine.

We are pretty much alone. What is the use of a doctrine if it is ignored by the economies that are supposed to follow our lead?

Mr. COOPER. The use of the doctrine ignored by two of the three largest economies is that things would be a lot worse if it were ignored by all three. I am not suggesting, however, that we should not continue, as we have been doing during the last 9 months, to talk to both Germany and Japan very seriously about this problem.

In fact, as you may know, just last month both of those countries announced measures that have to go through their legislatures, but both countries announced measures which would add substantial stimulus to the domestic economies.

Senator CHURCH. How long can we maintain current account deficits of these proportions?

Mr. COOPER. I did not hear.

TREASURY AND STATE PROUD OF THE DEFICIT

Senator CHURCH. We have a very large deficit which Treasury seems quite proud of, and State as well. The question is, how long can we maintain it, the largest in our history right now in terms of deficit and our trade balance, in our overall current account?

Mr. COOPER. The question imposed is a difficult one. The question of a durability of any phenomena depends on lots of circumstances. Let me give you a general answer, and then a particular answer.

I think the general answer is, as far as financing is available indefinitely, while it is true that the deficit is far and away our largest, it is also true that everything else, measured in dollar terms, is larger now than it ever has been.

THE CANADIAN DEFICIT

I cannot speak with confidence, actually, for the United States in the 19th century; I can speak for Canada. Canada ran proportionate to the size of its economy deficits larger than our current one for many years running. Why could that happen? It could happen because Canada was seen as a very attractive place to invest funds and the financing was available, largely from Europe and the United States, in order to finance those deficits in Canada.

Senator CHURCH. It was not running a balance-of-payments deficit during all of that period.

Mr. COOPER. No; running a current account deficit.

Senator CHURCH. A deficit in its balance of trade?

Mr. COOPER. That is right. That, similarly, is the deficit the United States is running now. The United States is not running a balance-of-payments deficit at the present time; it is running a current account deficit, and deficit in its balance of trade.

Another way of putting that is, we are importing capital from the rest of the world. Our ability to do that through time depends on the willingness of the rest of the world to invest capital in the United States. That depends on its own savings; it depends on investment opportunities in the United States.

I think that there is no well-defined answer to your question. To turn, however, to the particular circumstances in today's world—I mean, in the United States—it is, I think, anomalous for the United States, which is, after all, a capital-rich country, to be running a large deficit and it arises from a particular circumstance and a heavy dependence on oil and the fact that since 1974, with the big increase in oil prices, the locus of world savings, as one way of putting it, has shifted from North America and Europe to the Persian Gulf, essentially.

OPEC EXPECTED TO SPEND REVENUES

I view that as a temporary phenomenon; temporary, however, is not a matter of weeks or months in this case, but of years. Over the course of time, I would expect the OPEC countries to live up, that is, spend

up, to the revenues. I would also hope very much that our own dependence on OPEC oil would decline, and indeed, the President's energy program is designed, over the next decade, to help bring that about.

Therefore, the relevant time period for your question, I think, is that during the next 5 to 10 years. There, I think the United States could run a deficit on current account during this period.

I think it could be desirable, and we are working to bring it about, a better distribution of the deficits. That comes back to your first question concerning Germany and Japan. Those two countries are in surplus and it aggravates the global deficit that has to be handled.

Senator CHURCH. I interrupted you.

THE PURPOSE OF THE U.S. DEFICIT

Mr. COOPER. I was about to say, and this corresponds to my response to your question, that the deficits which the United States has been running serve the purpose of stimulating economic growth in other economies who cannot finance their adjustment as we can.

These countries, in turn, provide markets for our manufacturing and agricultural goods.

So, to recapitulate, the first point is adequate expansion in the world economy; the second element is that the industrial world must move forward in a long-term energy program geared to conservation; accelerated development of alternative energy sources and research and development.

The President's energy proposal for a wide-ranging program to reduce American dependence on imported oil as well as the multilateral efforts of the international energy agency are of major importance, and you may have noted last week, the members of the international energy agency announced the collective target for 1985 in their total importation of oil.

A third element is to insure that the international economic system functions effectively. Deficit countries must continue to have the opportunity and incentive to devise policies that will adjust their economies at a pace consistent with the realities of their social, political, and economic situation.

THE SUPPLEMENTARY FINANCE FACILITY

The supplementary finance facility, which is the topic of these hearings, is designed to provide such flexibility. The new IMF facility will make an important and impressive contribution, not only in augmenting the capacity of the IMF to lend to its member states, but also to assure the wealth that a source of official financing exists on a scale that is sufficient to cope with the degree of financial turbulence they are likely to encounter.

In short, the supplementary financing facility is as important in the psychological role of backstop of the system as it is a source of funds to be used.

The fourth element is that renewed attention must be focused on the task of facilitating economic growth in both the poor- and middle-

income developing countries. A few of these countries have a debt problem; as such, their development needs remain critical.

A resurgence of the world economy will be helpful to these countries, but they lack access to both capital and technology. It is here that both bilateral and multilateral economic aid play a critical role.

The programs play an important part in our program for a stronger and more viable world economy. They should be seen as such, and deserve the support of the United States.

FIVE ELEMENTS WOULD PERMIT SUSTAINED BORROWINGS

The fifth element emphasizes the importance of maintaining a local trading system so other countries can continue to earn from their exports. Given these five elements, we believe the deficits which respond to the OPEC surplus would gradually become geared to the underlying strength of the individual country's economies and their capacity to sustain external borrowings.

In so strengthening the base of our international monetary system, we would also be contributing enormously to the provision of an international environment conducive to effective foreign policy well beyond the economic components.

Thank you, Mr. Chairman.

Senator CHURCH. Thank you, Mr. Secretary.

A \$30-\$40 BILLION DISEQUILIBRIUM

As long as Saudi Arabia, the Arab countries, earn \$30 billion to \$40 billion more for the oil they sell than they can buy back in goods and services, do we not have a continuing disequilibrium in the world economy?

Mr. COOPER. Yes, we do.

Senator CHURCH. That means, \$40 billion or \$50 billion accumulated resources, by these half-dozen countries at most, is reflected by comparable deficit in the outside world, the consuming world?

Mr. COOPER. Right.

NO REAL SOLUTION TO THE DISEQUILIBRIUM

Senator CHURCH. Since Saudi Arabia is in a position to preserve that surplus as long as the cartel remains intact, at least for the foreseeable future, is not the Witteveen Facility something that takes care of the poor countries 3 or 4 years along with considerable lulls from the commercial banks, but it does not furnish us with any solution to this fundamental problem of disequilibrium in the world economy?

Mr. COOPER. That is correct. The Witteveen Facility takes that situation as given and is remedial, but does not offer a fundamental solution the disequilibrium.

Senator CHURCH. We have not been given a fundamental, comprehensive solution. We have not found an economist yet who has told us what that solution might be.

Do you have one?

Mr. COOPER. I think if one can abstract—if I could put it this way, if one can abstract from the dynamics of recent history, that is the fact that we went from a low energy price in one jump to a very high energy price, which was a purely political act by a group of countries

and the suddenness of that jump gives rise to what, in the course of history, I think, will prove to be the transitory problem of large imbalances in payments at the present time.

THE DEPENDENCE OF THE INDUSTRIALIZED COUNTRIES

Nonetheless, I think the underlying circumstances behind that are realized, namely the heavy and rapidly growing dependence of the industrialized countries on a resource which is at least, in current distribution of the reserves, not equally distributed around the world.

Therefore, a small group of countries command very high earnings from a scarce resource.

While I think that the decision in December 1973 to raise prices of oil was clearly an exercise of monopoly power, it was not merely an exercise of monopoly power. It did reflect what came to be clear as a disequilibrium in the underlying market for the commodity, namely oil, and some price adjustment was necessary. It is just that it took place with dramatic suddenness and probably in magnitude that was more than was called for at the time.

This is a somewhat longwinded background. To come back to your question, I think the only ultimate solution to this problem is to reduce dependence on the resource that is located so heavily in that one part of the world, combined with a gradual living up to the new higher incomes by the people that live in that part of the world, both sides at once.

And to just add a sentence, whatever ameliorative steps we take in the monetary system are not going to address that fundamental problem, but they can help ease the adjustment to that fundamental solution of that problem.

"NO" IS THE ANSWER

Senator CHURCH. The answer to my question is really "no."

Mr. COOPER. I would put it somewhat more generously.

Senator CHURCH. I have heard your answer from all the other economists. It really comes down to no, we have no answer now. Maybe future events will change the world's reliance on oil, but everybody knows that is a long time in coming.

Meanwhile, maybe they will absorb more of their earnings, but you cannot hypothesize a situation in which Saudi Arabia, with a small population, its political system and the control of wealth in the hands of just a few families could ever absorb such revenues and buy back in goods and services what they are extracting for the oil. So although you can postulate circumstances that may come by the turn of the century that would substitute other types of energy for oil or possibly just the exhaustion of the oil supplies in the Middle East that could finally find an end to this disequilibrium, but meanwhile we live with the reality of a \$30 billion to \$40 billion surplus of a cartel that can enforce that surplus since there is no real free market at the moment, and with the likelihood that one will develop soon. And I do not see how we can just keep on this course without the system cracking, the credit financing system of the world.

I do not suggest that that is about to happen, because we have enormous resources. On the other hand, I do not see how we can keep going down this path without having the system strained beyond the limits of its capacity to accumulate deficits of this size, year after year.

Now, that does not have a great deal to do with this facility—this is by your own admission a temporary palliative, and, as such, I think that it is necessary. Just looking down the road, I find myself very pessimistic, both in your own testimony and in Secretary Solomon's testimony, you used the phrase "internationally responsive economic policies" Do you mean by this phrase policies which will enable debtor countries to meet their debt service payments?

Mr. COOPER. Senator, if you will permit us, before I answer that question, just to comment on what you said before?

Senator CHURCH. Sure.

NOT A PANGLOSIAN PICTURE . . . BUT,

Mr. COOPER. I would not be so pessimistic. I do not want to be Panglosian and paint a rosy picture over, surely, a difficult situation, but I do not think the situation is as gloomily as you portray it.

I would suggest, because you mentioned something about the end of the century, for example. I would suggest, if the OCED countries were to meet their targets, which they set last week in terms of dependence on imported oil—that will not be an easy task, but it is possible and feasible by 1985—I would suggest that by that time this problem which we are now wrestling with would have substantially disappeared. That is to say—

Senator CHURCH. I do not understand that. Why? What they have agreed to is to reduce consumption. I do not see how that solves your problem.

Mr. COOPER. And increase alternative sources of supply.

Senator CHURCH. That would be helpful.

Mr. COOPER. The focus of the target is dependence on OPEC oil and what is a combination in restraint of our demands for OPEC oil plus, and I would not underrate this, a living up, the spending up, to higher levels of income of the OPEC countries themselves, including Saudi Arabia.

THE SAUDI PERSPECTIVE VERSUS OURS

It is interesting from the Saudi Arabian perspective, as distinguished from our perspective, they see their oil as a finite resource in the ground which they want, over the course of the next generation, to convert into the physical and human capital stock of a modern industrial society.

It is a very ambitious task, but, nevertheless, that is their target and they have a spending program that corresponds to that target.

I think that is far from beyond the realm of the conceivable that if we can exercise restraints on our demand for OPEC oil the OPEC countries, on their side, can, in fact, comfortably spend the kind of earnings which they are now earning by that time.

I do not include everyone. There are some small sheikdoms that have enormously high incomes, but as we go through the major countries, many of these countries are on a current commitment basis to spend their revenues.

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MORTGAGE OUR FUTURE

Senator CHURCH. There are all kinds of differences between Iran, Venezuela, and Saudi Arabia. It looks to me that we are accepting—

few people are accepting—a situation where that the ownership of \$30 billion to \$40 billion a year of Western World resources are being shifted, to three or four countries; and that is \$3 trillion to \$4 trillion or \$300 billion to \$400 billion.

It seems to me that we are just mortgaging our future in current consumption.

MR. COOPER. We are borrowing a lot, there is no question about it.

Senator CHURCH. The rate is already pressing our credit system. There are \$75 billion in loans from commercial banks to Third World poor countries which now have to have a lending facility to service their debts, and yet both State and Treasury are quite sanguine about the future.

I hope they are right. I do not see that conservation is going to be all that helpful in correcting this disequilibrium in the near term, even if these rather ambitious goals are achieved, because I would think that as long as Saudi Arabia has the wealth, it can cut back delivering very drastically and still up the price. If Saudi Arabia has some pressures from the rest of the world—and there are heavy pressures in Saudi Arabia that need to be controlled, including the pressure of its neighbor Iran. We have made Iran one of the most powerful countries in the world militarily and it has a pressing internal reason to be very hawkish about the price of oil.

So the adjustments that economists see in kind of a vacuum of pure economic theory are not likely to work in a market that is not free of control by a cartel that is subject to very heavy political pressures. That is why I am pessimistic, as I look into the future. It seems to me that your answers do not jibe with what appear to be the political realities of the region.

WILL SAUDIS CUT BACK IN PRODUCTION?

MR. COOPER. Are you suggesting, Senator, that Saudi Arabia, one way or the other, will be induced to cut back substantially on its production in the next 6 to 7 years?

Senator CHURCH. If Iran goes down, they can cut back drastically on their production without reducing prices. In fact, they can continue to increase prices sufficient to protect their surplus.

MR. COOPER. That is right. There is no question but that the capacity for mischief is there. The only thing I could add to that is that Saudi Arabia so far has, on the whole, been a responsible country and that while some countries in the region can exert political pressures on it, although in recent months Iran has not been one among the most hawkish countries in terms of price it is also true that, as you point out yourself, Saudi Arabia has developed, by virtue of its investments in the United States and elsewhere, a tremendous stake in the viability and continued well-functioning of the Western economies. And again, it is not merely an economic stake, it is a political stake as well because Saudi Arabia sees itself a political future, to some extent conditioned by political developments in the Western industrial countries.

Saudi Arabia has taken great interest in political developments in Europe, for example.

THE IMPACT OF IRAN ON SAUDI ARABIA

Senator CHURCH. Saudi Arabia's political future may be affected more by the actions of her neighbor, Iran, than developments of

Western Europe or the United States. It is hard for me to reconcile your economic projections with approval of F-16 and AWAC sales to Iran, that could easily be translated into added pressures on Saudi Arabia.

Mr. COOPER. Our understanding of the use of AWACs in Iran is that they will not be directed at Saudi Arabia. That would be overkill, to say the least, if that were the principal motivation.

PRODUCTION CUTBACKS IN SAUDI ARABIA

Senator CHURCH. Saudi Arabia did not reduce its production, nor increase its oil as it indicated it would when they refused to go along with the 10-percent increase in price. We thought that they were going to do that and we applauded them for it, but we found out later that they did not.

Mr. COOPER. They tried on a daily basis, and in fact, succeeded on a daily basis, to increase their production substantially, but for the period as a whole, that was offset by two unforeseen developments. One was exceptionally heavy weather in January and February in the Persian Gulf and the other was the fire. It cut back the throughput and compelled Saudi Arabia to cut back production. Immediately before the fire, production was well above any previous levels.

Senator CHURCH. You discounted entirely that another reason may have been heavy pressure from Iran.

Mr. COOPER. The application would suggest that the fire was a sufficient reason to cut back. Whether that was the only reason, then I do not have a speculation. They could not move the oil from their biggest field following the fire.

Senator CHURCH. When was the fire?

Mr. COOPER. I think it raged for 3 weeks and was brought under control, but left considerable damage to the pumping system after that that had to be repaired. This is by way of explanation of why the average daily output, in the first 6 months of this year, essentially, was disappointing compared to the point that you mentioned, although individual production frequently got up.

Senator CHURCH. What is it now? Have the repairs been completed so that daily production now could measure up?

Mr. COOPER. I am not aware of just what the state of repairs are, whether it has been fully repaired or whether it is up to full capacity. I do not know.

DOUBTS OF WEATHER CAUSING SHORTFALL

Mr. LEVINSON. The Saudis have announced that allowables are down to 8.5 million barrels a day, substantially less than was projected for the first half of the year. And also, there is a substantial doubt as to whether the weather is a full and sufficient reason for the shortfall in production before the fire ever occurred. So that what we have now is the explanation of the weather, in the initial stages, as to why production did not reach the targeted levels, the fire and then the announcement recently that the allowables are back down to 8.5 million barrels.

Mr. COOPER. I was addressing the historical question of the first half of this year. Now, what has happened since the change in the pricing structure, the Saudi Arabian announcement was in connection with their intention to hold their price in position as of the meeting last December.

OPEC AND THE WESTERN WORLD

Senator CHURCH. I do not have much confidence that the OPEC cartel is going to be managed in a way that accommodates the needs of the Western world, even though Saudi Arabia may have some motive for doing that because of her investments. I think that the different position of Iran and Venezuela and other countries in the cartel who would like to be controlling.

Mr. COOPER. I think that one cannot assume that OPEC will manage its affairs to accommodate the desires of the Western World. Rather, I would put it this way. I think that OPEC, at least the leading countries in OPEC, will try to manage their affairs in order to pursue their own interests, and included in their own interests is a perception of the importance of the welfare of the world economy as a whole and the domestic economy.

Senator CHURCH. I will tell you when I will begin to believe that. I will believe that when the surplus begins to go down and you have not shown us any evidence of that yet.

Mr. COOPER. It has gone down since 1974.

Senator CHURCH. 1974 was a very special year because, by your own testimony, that was the year that they increased the price of oil by 400 percent. Since that time, the surplus has remained in the range of \$30 billion to \$40 billion a year.

Paul, do you have any questions?

Senator SARBANES. Thank you, Mr. Chairman.

PRUDENCE OF PRIVATE BANK LENDING

We have held some hearings in this subcommittee where serious questions have been raised on the basis on which and the advisability of some private lendings that have taken place in one country or another around the world. Do you have some concern of the prudence and the responsibility that is reflected in some of the lending by the private banking system in various places, mostly the underdeveloped countries?

Mr. COOPER. I do not think I would single out underdeveloped countries in this regard, nor do I think that banking prudence, the prudence of bank lending, has been notably laxer in the last few years than other periods of time.

It is true, in general, that there is a diversity of practice across the banking community. Some banks are more go-go in their banking behavior than other banks. Some banks engage in what even at the time would be identified as imprudent lending and after the fact proves to have been imprudent lending. That is true of domestic loans as well as international loans, and I would have thought, as a general characterization of the behavior of the banks in the international banking in the last couple of years, that their behavior has not been imprudent.

That is not to say that there have not been, and will not be, individual loans which prove to be bad ones or prove to be shaky ones. As a general characterization, I would have thought that from the point of view of banking, these loans in general have not been imprudent. From the point of view of the system as a whole, they have been absolutely essential.

Senator SARBANES. What do you mean, from the point of view of banking?

Mr. COOPER. The contrast I was making, from the point of view of the system as a whole, the function of the system as a whole, this lending has been absolutely essential, as a different criteria from the criteria that a particular bank would apply to particular loans, and that is what I meant. From the point of view of the banks, looked at from the perspective of the loan officer of the banks, it is a very different perspective than somebody asking how the international system as a whole functions.

PRIVATE BANKS AND THE IMF PROGRAM

Senator SARBANES. What is your view of private banking that undercut or conflict with or weaken—let us say, IMF policy, where the IMF has developed a particular program with respect to a particular country and the private system perceives it in a sense without any regard to that.

Mr. COOPER. I think that private banks proceed on the criteria that they, themselves, apply to their loans in the case of international banking are a combination of the particulars of the loan itself, whatever the money is used for, plus the particulars of the country to which the loan is being made. That is a distinction we do not worry about in domestic banking.

I am really not aware—your question puzzles me, in a way. Again, speaking generally, the banks, in looking at the second criteria, that is the country criteria, pay a lot of attention to the relationship of the country to the International Monetary Fund. In general, I would have said that there is a positive, not a negative, correlation between the willingness of private banks to lend to a country or to various borrowers in the country, and the standing of that country within the International Monetary Fund.

THE PUBLIC SYSTEM SAVING THE PRIVATE SYSTEM

Senator SARBANES. Of course, to some extent, a crisis situation can be created by the private system that the public system just then comes along and has to, in effect, save. Does that not happen?

Mr. COOPER. It can happen. In this case, the crisis was created, as we were speaking of earlier, by the sharp change in oil prices and private banking filled the breach, kept the system going, and gradually in different ways, the public authorities have come in to fill some of the gaps.

Senator SARBANES. We had a hearing the other day involving Indonesia where it seems fairly clear that the private lending contributed to a crisis situation which finally required public solution and, in fact, almost demanded it. Imprudent private lending was in a sense, not imprudent because the consequences of their imprudence could not be tolerated, and therefore the government of Indonesia and other governments had to respond in such a way as to not allow the consequences to run their normal course.

Is that not a recurring pattern?

Mr. COOPER. It is an occasional pattern. We have found the same thing in our country with the Franklin Bank, as you will recall. That kind of thing can happen in the banking world.

REPORT OF THE NATIONAL ADVISORY COUNCIL ON INTERNATIONAL MONETARY AND FINANCIAL POLICY

Senator SARBANES. The National Advisory Council on International Monetary and Financial Policy and their special report on the banking facilities says, among other things:

In endorsing the facility and speaking strongly for it, in doing so, to improve the creditworthiness of members, thus helping to insure adequate and continued flows of private market finance.

Then, later on, it says, "in fact an important feature of the facility is that it will facilitate continued large-scale borrowing from banks and other private market sources." How do you harmonize these things? IMF comes along, this is going to be conditionality, at the top range, as I understand it, in terms of supplementary facilities and access to it.

A very careful analysis is done, and the program—and the country subscribes to a disciplined program. Leaving that aside, if that causes problems. But how do you harmonize that program with what is done in the private sector, not to recreate the situation?

Mr. COOPER. Senator Sarbanes, what that sentence you read refers to is the underlying structural fact that, given the size of payments and balances in today's world, we must rely heavily on private financing, to continue to recycle was the word that was used a few years ago, and it would be of the greatest consequence to the international economy as a whole if that recycling process were to dry up in some way.

But a number of banks have become somewhat anxious about the expansion of credit, continuing in the same fashion, and that therefore the assertion that the IMF into the process with new lending capacity on somewhat different terms, somewhat longer terms than just this normal under the IMF funding.

But with a program that would bring countries' payment conditions back closer to equilibrium will, on balance, be a stabilizing element in the world economy as a whole and will enable private lending, therefore, continue to take place with greater confidence than it would in the absence of the facility. And that is the link in the sentence that you read.

A DE FACTO LINKAGE

We do not have, at the present time, any formal linkage between IMF, standby, a creation of a standby with a country, or IMF lending of a country and private bank lending to the country. There is a de facto linkage in that the agreement by country for standby differential with the IMF, in effect, amounts to "Good Housekeeping Seal of Approval," which encourages banks in terms of the viability of the policies of the countries in question. It is entirely up to them, up to the private banks, what they do with that new information. There is no formal linkage between the IMF and the bank lending itself, except in this regard, that the IMF may stipulate limits as a part of its package proposal on the total of that borrowing by the country, but no link between IMF and particular banks.

Senator SARBANES. I want to ask you a couple of technical questions.

Senator CHURCH. Senator, before you do that, could I put something in the record? I made a point earlier on that I found the Sec-

retary's argument unconvincing that the surplus is going down. Our latest figures show the OPEC surpluses are going up—\$15 billion anticipated in 1977, higher than 1976, and higher than 1975.

Senator SARBANES. I am interested in how the Witteveen facility is going to actually work, as it relates to various credit funds?

Mr. COOPER. Let me start off from memory and then correct it if it is not right.

EACH MEMBERS' QUOTA

Each country, as you know, each member of the Fund has a quota with the International Monetary Fund which is divided into different tranches, five of them. The degree of conditionality associated with the reserve credit tranche are considerably less than the higher credit tranches. For the reserve, there is basically no conditionality, merely a statement that the country has a balance-of-payments need. The effect is the country borrowing its own money back from the IMF. Then, as it goes into the credit tranches, the IMF puts on a higher degree of conditionality and somewhat stiffer terms and terms of interest rates, a graduated thing.

The Witteveen Facility will be integrated into the system starting with what is called the second credit tranche, that is, past the reserve credit tranche and the first credit tranche and into the range of the higher conditionality associated with that.

I am told that, as a gradual matter, that there is not a substantial difference in the degree of conditionality among the higher credit tranches, although in principle there could be, and the idea is that as a country goes into the higher credit tranche, it can draw not only the credit tranche. But it can also augment its borrowings from the Fund, from the Witteveen Facility, so it can get more money than it would be entitled to if it were brought to focus on the second credit tranche as a certain one-fourth of its quota is the second credit tranche and that is a certain amount of money for a particular country.

Under the proposed scheme, it could draw more than that amount of money by virtue of the Witteveen Facility and meeting the conditions for the second credit tranche, augment the effect of the funds. Similarly, for the third and fourth credit tranches and a decision was taken at Jamaica in January of 1976, that in exceptional circumstances the country might borrow beyond its fourth credit tranche, what the Witteveen Facility will do for those exceptional cases is provide the funds for drawings where a country has an adjustment requirement that is more than can be handled by the financing through normal ways. That can be augmented, perhaps substantially, and also give the country some more time than would be true under the normal IMF procedures, because the Witteveen Facility is payable over a longer period of time, in order to undertake the adjustment.

It is envisaged that, while it is a special source of funds, to some extent has separate rules governing its views, in fact, it seems to be integrated to the conditions that are imposed.

THE FACTORS DETERMINING A COUNTRY'S QUALIFICATIONS

Senator SARBANES. What are the factors that will enter into the judgment as to whether a country qualifies to make use of the Witteveen Facility? That is a judgment made by the Directors of the Fund?

Mr. COOPER. That is correct. On the needs side, the factors are whether the size of the payments and balance is exceptionally large relative to the size of the economy, and that the period of adjustment required is longer than the period of adjustment, 3 to 5 years, to which is normally available under normal times.

On the conditionality side, then, the Fund would lay down conditions that are appropriate to that longer period of adjustment and not—here, I express the hope, because of course, we do not have an experience with this facility—that the Fund will place much greater emphasis on resource allocation from consumption to investment, essentially productive investment, than it normally does or that is normally appropriate for it to do in its operation over the years. Often the representative country is a country which has an excessive expansion of demand. The role of the Fund essentially is to try to get the macroeconomic policy of the country under control.

OUR CIRCUMSTANCES NOW

The circumstances in which we find ourselves now involves large payment deficits which are not associate with mismanagement, not always associated with mismanagement of domestic demand and I would hope, in using the Witteveen Facility, IMF would take that critical difference into account and address its conditions, its program, which it works out with the country, to those circumstances that we find ourselves in now.

Senator SARBANES. How is the decision of the American voice on the IMF Board on issues of this sort, how is that reached?

THE VOTING SCHEME

Mr. COOPER. We have a representative on the Board. He is kind of an executive director. He is 1 of 20 people. The IMF has a formal scheme of voting, weighted voting, and it happens that the United States has more votes than any other single executive director, one-fifth of the total votes. As you can imagine, many of the decisions are taken essentially on a consensus basis without a formal vote.

If it comes to a formal vote because of the heavy weight of votes that the United States have, the American Executive Director has a considerable voice in the discussions of the executive board. But the executive board, of course, is sort of the management and control board, not an operating board in the sense that the negotiations between the IMF and the country are undertaken not by the Board, but by the staff and the guidance of the Managing Director, and is a product of those negotiations that are then put before the Board for discussion and approval.

VOICE OF AMERICAN EXECUTIVE DIRECTOR

In addition, the Board, from time to time, has general policy discussions abstracted from any particular country case. In both instances the American Executive Director has a substantial voice. Of course, it is now managed.

Senator SARBANES. In our own Government, how is the process determined as to what the voice of the American Executive Director should be?

Mr. COOPER. The Executive Director of the United States maintains close, I would say daily, almost daily, contact with the Treasury Department, the international side of the Treasury Department, the Assistant Secretary for International Affairs, and the Secretary for Monetary Affairs, and takes policy guidance from those Government officials and keeps them informed about issues that, in his judgment, require policy guidance.

He does not burden them with all the details, but on issues that raise questions of policy, he consults with those officials. Then those officials in turn are in touch with other agencies of the U.S. Government that have a continuing interest in the functioning of the U.S. military system, including the Council of Economic Advisers and the State Department and other agencies.

Senator SARBANES. There is not an official interagency group that concerns itself with the matters?

Mr. COOPER. There is an official body that goes back to the Bretton Woods Act, the National Advisory Council on the International Monetary Fund Affairs, or something like that, international monetary affairs, an official, formal, interagency group that includes, as members, more agencies than the ones I mentioned. It is the place where questions concerning financial policy can be discussed. As a practical matter, that body devotes most of the overwhelming bulk of its attention to the development to bank loans, to Government loans, loan petitions on our own Public Law 480 and things like that. That is a place where IMF policy can, and is, discussed.

The Treasury Department chairs that group. It is the same officials ultimately.

IMF TO INCREASE SOURCES

Senator SARBANES. The IMF is about to increase the sources by developing a seven quota.

Mr. COOPER. Two things. There is the six increase and that is to be discussed in the next round of quota increases. It has, in its charter, if I recall it correctly, the obligation to review at 5-year intervals the adequacies of the quotas and we have, in the last couple of years, been through one round of quota increases that are now agreed in principal and, indeed, the United States has ratified its quota increase. We hope that that quota increase will go into effect by the end of this year, or shortly after.

Senator SARBANES. Those quota increases are across the board and involve all the nations that participate in IMF?

Mr. COOPER. All member major countries.

Senator SARBANES. The Witteveen venture is a marked departure from the universality, basic, IMF arrangement, is that not correct?

Mr. COOPER. In that respect, yes. IMF borrowing from a limited amount of countries, not all member countries.

Senator SARBANES. Making it available by the terms of availability by a limited amount of countries, is that true?

Mr. COOPER. Yes, but a number of countries, and all member countries of IMF are eligible, but there are criteria laid down that would limit that number.

THE LIMITATIONS OF THIS APPROACH

Senator SARBANES. What are the limitations in the long run of the departure from the universality and adoption of this more limited

approach? I guess responsibilities for making the monetary system work and the precedent that is established for the future?

Mr. COOPER. That is a good question. Let me put it in some historical perspective. While it is a departure from universality of the Fund, it is not the first departure in that regard. There have been earlier occasions on which the IMF has turned to a subgroup of its membership for special financial support. The first instance that I am aware of goes back to 1961 to which a special arrangement called a general arrangement to borrow was created, involving the member countries, the 10 industrial countries which, under special circumstances, would lend to the IMF and augment the resources of the IMF.

Then, with the tremendous increase in oil prices in 1974, a special so-called oil facility was created by the IMF which, again, was applied by a limited number of members, in that case, the oil exporting countries, for relending by the Fund to all member countries.

Now, this Witteveen Facility is another in this class of arrangements. It was anticipated in the articles of agreement that the IMF might borrow outside the normal subscription system, which is the universal system. It was anticipated that the IMF might borrow from member countries, or even from the market, which it has never done, in order to augment its resources.

So this has some antecedent—not exactly antecedents, but some antecedents in that sense. The normal quota increases link three different things in the IMF. They link the in-payment of funds, the subscriptions, as they are called. That is what gives IMF resources, as a practical matter. The currencies of many members of the Fund are not usable, so the usable currency the Fund gets through a quota increase is limited to two dozen, three dozen countries.

Second, these changes in quotas, increase in quotas, can affect the voting rights of members of the IMF. Third, they affect the drawing rights of member countries in the IMF. The three are linked together historically and tend to go together.

What the special borrowing facilities, like the Witteveen Facility, do is to break the link between the provision of resources to the Fund on the one hand, and borrowing rights and voting rights on the other hand.

CONTRIBUTING COUNTRIES WILL NOT GET SPECIAL VOTING RIGHTS

The countries contribute to the Witteveen Facility will not, by virtue of that contribution, get special voting rights, nor will they get extra drawing rights, although it is a feature of the supplementary financing facility that if a country's payment position turns around, it can reverse its loans to it.

The breaking of the link between those three aspects of the member countries' relation to the Fund is what is in the future. It is hard to say. It is possible that a number of countries will not look with favor on a renewal of the Witteveen Facility for example. They may argue we have already had some part of this. If we want to be a member of the Fund, we want the voting rights to go along with it. That could tend to push the future toward appropriate quota increases.

On the other hand, there may be—and I would argue it at the present time—special circumstances operating in the world economy in which

the IMF needs a special dual service resources, quite apart from the normal review of quotas, really. The Witteveen Facility is designed to meet a special need at a special time, without prejudicing the facility.

Senator SARBANES. Thank you, Mr. Chairman.

Senator CHURCH. Thank you very much.

Mr. Irving Friedman is our next witness.

STATEMENT OF IRVING FRIEDMAN, SENIOR VICE PRESIDENT AND SENIOR ADVISER FOR INTERNATIONAL OPERATIONS, CITIBANK, NEW YORK, N.Y.

Mr. FRIEDMAN. I apologize for not having a prepared statement. I testified just last week before a congressional committee on a very similar topic and I suggest that we circulate that prepared statement, with your permission. I will not read it or summarize it; just regard it as having been given to you.

Senator CHURCH. Very well, if you wish we can incorporate the statement in the record.¹

Mr. FRIEDMAN. Thank you very much.

ARE THE BANKS WILLING TO CONTINUE DEFICIT FINANCING

Senator CHURCH. Treasury Department officials have testified before the subcommittee that all importing nations are expected to continue to run large deficits into the next decade. The need for deficit finance can only be met by private banks who continue to serve two-thirds of that credit, \$50 billion annually over the next 5 years.

Do you believe the banks are willing and able to continue in this volume of international balance-of-payments lending?

Mr. FRIEDMAN. Well, I think that in terms of the banks' ability to continue such balance-of-payments lending, the answer is yes. Yet, this answer has to be qualified by the fact that, in the last few years, we have been living in a rather paradoxical situation of simultaneous low loan demand in the industrial world and large loan demand in the developing countries. Another paradox is the simultaneous development of a low loan demand from the private sector and a large loan demand from the public sector.

Thus, the ability of the private banks to meet the demand for funds arising from the public sector of the industrial countries and the developing countries has been relatively easy, given the low loan demand in other sectors of the world.

At the present time, I believe that, for the foreseeable future, the international banking system would be capable of extending all of the credit that would be demanded, provided that the borrowers were to be regarded as creditworthy. Whether we would want to do so is another question. Our willingness is going to depend on the creditworthiness of the countries in which we find the entities which are potential borrowers in the public or private sector. Then it is going to depend on whether or not there are entities within those countries that are creditworthy in their own right. Much of the borrowing done outside of the United States, from U.S. banks or other bodies, arises in the private sector, so that you do have, for the most part, a com-

¹ See p. 174.

bination of whether the individual borrower is creditworthy and, at the same time, whether the country is creditworthy. An overall evaluation of a country would indicate whether a country could be regarded as creditworthy from a country viewpoint.

As I have said on other occasions, Mr. Chairman, I personally think that the private bank lending overseas is going to rise. Whether it will rise as rapidly, as, for example, the rate of increase in the past few years, I do not know. In addition, I do not know how much of this lending will be a function of the rate of inflation foreseen for the future, or how much of the increase in lending was a mirror of rapid rates of increase in inflation in past years. I do not belong to the school which predicts that we will have lower rates of inflation.

AN UPWARD TREND IN FOREIGN LENDING

I expect that overall level of foreign lending to go up over the coming years, although I do not predict straight lines in anything. I, for one, have relived much of my professional life today in all of the testimony—from where I started and to where I am now. In my experience, I have never heard of precise predictions coming true. They are very useful, and we need to have them as guidelines for thinking. However, I think that such lending is largely going to depend on what countries will do.

If developing countries lose their creditworthiness, they will not be able to borrow. What then results will appear to be an ironic situation: The less creditworthy a country is, the smaller its deficit, because it cannot borrow to finance a larger deficit.

These are all pretty complicated factors, but they add up to a belief that lending will increase.

ZAIRE UNCREDITWORTHY

Senator CHURCH. We had some testimony the other day about Zaire, which does not bear out the proposition that when a country becomes uncreditworthy, it does not get credit. There is a rescheduling going on, stretching out the debt if the IMF comes in with the money, and everybody seems agreed that Zaire is broke, about as broke as any country in the world today.

SHOULD ALL LENDERS HAVE EQUAL STANDING IN TERMS OF REPAYMENT

But nevertheless, the loans are being turned over, and credit is being extended. There is a phrase, "equal debt-sharing burden," that emerges from all of this. Do you subscribe to that, that all lenders—official, governmental, or private—should have equal standing in terms of being repaid by a bankrupt government, or in terms of sharing the losses?

NO LOANS TO ZAIRE SINCE 1975

Mr. FRIEDMAN. When Zaire lost its creditworthiness in 1975, it lost its access to private bank credit. There is even the peculiar situation that, while Zaire had over \$3.5 billion in commitments and loans outstanding, Zaire was only able to draw down about one-half the com-

mitments because lenders were not willing even to allow them to draw down on even the committed funds.

I think it is fair to say that Zaire, when it lost its creditworthiness, lost its ability to borrow. It might be asked, why did Zaire lose its creditworthiness in 1975? Why did not banks foresee that in 1974 Zaire would be losing its creditworthiness? Why was there not more provision the year before? In that sense, I think the case of Zaire is very interesting to discuss. Nonetheless, I do think that it is fair to say that Zaire represents a country which lost its creditworthiness and thus could not borrow.

Senator CHURCH. Let us put it this way. Zaire's debts to government lenders were rescheduled in 1977 because of its inability to meet those schedules, because it was in default. And these payments now have been stretched out with a 3 or 4 years' grace period; and under the terms of the rescheduling, we have been told Zaire has pledged to seek a comparable arrangement from its private creditors.

THE PARIS CLUB AND THE LONDON CLUB

That brings up the Paris Club and the London Club. You are a part of the London Club, I understand. What has happened to those comparable arrangements?

Mr. FRIEDMAN. I do not like to go over ground that has been covered by your committee before, so stop me if I am.

Senator CHURCH. Have comparable arrangements been made, in your judgment?

Mr. FRIEDMAN. I think that what the private banks have tried to put together for Zaire will be more than comparable, provided the private banks succeed. I would not want to say, as of this moment, that this private bank effort will succeed. The comparability arises in the fact that, as you undoubtedly know, the banks have undertaken to raise for Zaire \$250 million of new credits which are to be used for new imports. These new credits are not to be used to repay debt to the private banks. They are to be used for specific imports which are needed in the economy.

This effort by the banks was based on the theory that, when you had a country which was as broke as Zaire but had the real physical capacity and the potential of Zaire, the thing to do was to work with the country to try to reestablish it as a working economy.

There has been a considerable amount of confusion on this point because, in the context of one particular default of a 5-year credit, the suggestion has been made that there would be a 6-month letter of credit which would be merely a technical device to implement the 5-year credit. The commitment to Zaire—and this makes it comparable whatever the terms may be as they evolve and are finalized—is going to be a 5-year credit available for imports to Zaire of \$250 million. This amount would be very much larger than the amount that will be paid back to various private bank debtors.

AN ADDITIONAL \$250 MILLION FOR ZAIRE

Senator CHURCH. A minute ago you said when a country became uncreditworthy, it did not get any more credit; and now you are discuss-

ing \$250 million more for Zaire, who is very broke. Is there not some inconsistency?

Mr. FRIEDMAN. I do not think so and for the following reason. We are taking the position that Zaire has to reestablish its creditworthiness before it can get new loans. The question that can be raised is: What do you regard as criteria for judging the reestablishment of creditworthiness? Being broke, per se, is not the decisive factor, although it is undoubtedly one of the great handicaps in reestablishing creditworthiness.

What have we made the criteria? One is that Zaire pay back its debts to the private banks and keep up its current payments on the current servicing of past debt. Second, that Zaire had to have a second and third credit tranche standby agreement with the Fund, in order to have what Secretary Cooper referred to as a Good Housekeeping seal of approval. We wanted an outside body to be judging the economic and particularly the financial and monetary performance of the country.

Third, the Fund program had to be, in effect, long enough, to make sure that it was not just on paper, but that it was going to be implemented. Fourth, that other measures that were necessary for the revival of the economy, like the prudent management of various sectors—transportation, foreign exchange, the budget, the running of its plantation systems—would have to be taken before it could reestablish its creditworthiness.

Then, the moneys that would be available would be phased in over a period of time in order to be sure that the plan Zaire adopted was being implemented.

That is, approximately, what we have set up as regards the criteria for the reestablishment of creditworthiness. What the banks are now considering among themselves is whether this arrangement is good enough. If they do not think it is good enough—and you can see that our criteria are not only those of the Monetary Fund but many more—they are not going to put up the money. It is for this reason that I hesitate to commit any other bank at this moment in time, or to say that we have succeeded. This is only what we are trying to do.

SHOULD ZAIRE PAY PRIVATE BANKS FIRST?

Senator CHURCH. In the case of Zaire, do you think that private creditors, private banks, should be repaid first?

Mr. FRIEDMAN. To my mind, it is not a question of whether you are repaid first or last. When a private bank lends abroad, it lends on the assumption that it is going to get paid back: The contract that is made with the private borrower is a firm contract, made with all good faith on both sides that both parties are going to execute it. The question that arises is what happens in a case of difficulties, as in Zaire? Zaire is especially interesting because it is the one place where many of these issues have come together.

The attitude that I have with respect to Zaire is that it is in the interest of Zaire—as a country which is going to need a net inflow of capital over many years to come which it does not see as coming in sufficient amounts from public institutions—to maintain its credit-

worthiness with private sources of funds. The only way it could do this was to maintain a record of debt servicing. There is then this difference between private and public sources of funds: It is possible, if a country is dealing with public agencies to maintain its creditworthiness, in the sense of accessing the funds, without this full servicing of debt.

THE INFLUENCE OF THE WORLD BANK ON MR. FRIEDMAN

I am greatly influenced in my attitude toward Zaire by my experience with the World Bank, where we had always taken the view that we had to be repaid, because if the World Bank were not to be repaid, it could not do its work. Certainly, I also feel that from the perspective of the private sector, a private bank cannot engage in international lending unless it feels that the borrower gives the highest priority to servicing the debt owed to the private bank. If the bank does not have this confidence, it does not know where it will be.

This is a very different situation from that of the public institution that can decide to reschedule or postpone, as the United Kingdom has done. Indeed, in the past, the United States has forgiven public debt from time to time because it felt, that as a political evidence of good will, it wished to take this political step.

Senator CHURCH. Your answer, really, is yes?

Mr. FRIEDMAN. If I had to say yes or no, I would rather say yes than no.

Senator CHURCH. I think you have said yes. You have explained the reasons. The answer is yes; you do think, in that situation, private banks should be the first to be repaid.

Mr. FRIEDMAN. Senator, may I comment on this? I do not want to seem to be implying that, in saying that the private banks should be repaid, that, therefore, they should be repaid ahead of public institutions. I think that this is a separate issue which is worthy of an explanation as to whether or not public institutions take a view similar to private bodies.

Senator CHURCH. I understand.

CAN ZAIRE REPAY WITHOUT IMF CREDITS?

Can Zaire repay the private banks without IMF credits?

Mr. FRIEDMAN. I do not know the answer to that. What has happened this year, for example, is that Zaire has had a shortfall with respect to earnings from copper because of the fall of the copper price and delays during the incidents when shipments were interrupted, and with respect to earnings from coffee because of the recent declines in the price of coffee and pricing arrangements.

Still, by restricting its imports further, Zaire's balance of payments is in relatively good shape.

So what Zaire has done is to apply the adjustment process to the consumption of its people. In my own opinion, it has gone very far indeed, both in terms of consumption standards and the latter and a shortage of necessary inputs for its industry, especially transportation equipment.

The question is then, if Zaire did not get relief from the public rescheduling, which does provide relief, or if it did not get relief

from the Fund, which does provide for financing, could it have tightened its restrictive measures on imports even more in order to bring about an improved balance of payments?

I think it would have been extremely difficult. A situation very well might have occurred in which the rescheduling of all kinds of debt was necessary, including that from private banks. A country can restrict only to a certain point. Beyond that point, it really becomes impossible.

PRESSURE BEING PUT ON COUNTRIES WITH LARGE DEBTS

Senator CHURCH. Both private banks and official creditors are putting increasing pressure on countries with large debts, running balance of payments deficits to work out a stabilization program with the IMF, your reference to the Good Housekeeping seal of approval.

WHAT IF COUNTRIES REFUSE TO PAY?

We also know that some countries are finding it politically difficult and some may soon may find it politically impossible to accept these IMF programs. What, in your opinion, would the private banks do if a country like Peru, for example, which owes the banks \$3 billion, refused to accept the IMF program and instead sought new bank credits as a condition for repaying the old?

THE CASE OF PERU

Mr. FRIEDMAN. In the case of Peru, if I may say so, we have had a very recent historical experience. That is exactly what happened in 1976, just a little more than a year ago. At that time, the Peruvians approached the private banks for a very substantial credit, which totaled \$400 million, of which the U.S. banks' portion was about \$250 million.

At that time, the Peruvians came up with a program and with a statement on the outlook for Peru. In the opinion of some of the private banks, this program was not adequate. The Peruvian balance-of-payments outlook was not such as to give confidence to private lenders.

Therefore, I could not recommend, in the case of our own institution, or to others, participation in some sort of syndication of the loan for Peru.

So we recommended to the Peruvians that they go talk to the IMF. They responded and said they did not want to talk to the IMF for political reasons. They found, within their own government, that there was a desire not to talk to the IMF.

We told them, in that case, that they would have to talk to the private banks. Our views on the country's outlook were quite explicit. We said quite explicitly that our evaluation would probably be more stringent than those of the IMF because ours was a private bank, and private banks had to give much more emphasis to the problem of servicing and repayment than would the IMF. Private lenders and funds were involved, not governmental funds. Therefore, the Peruvians would have to expect that the country conditions that we, instead of the IMF, would require would be more difficult to achieve.

If I may say, I made a personal prediction that Peru would never do this again, because Peru would find it easier to go to IMF than to go to private banks.

They did decide to deal with the private banks. We did have an agreement with them. If I may say so, we had a considerable amount of criticism from various quarters that the private banks were imposing conditions on countries. We did not impose conditions in terms of their domestic policies. What we are saying is that Peru had to present a plan according to which the projection of its cash flow and its balance of payments would give a private lender reason to believe that it was going to be repaid.

PERU AGAIN APPROACHES CITIBANK

Then, on the next go-round, this past spring, when the Peruvians approached us again—

Mr. LEVINSON. Did they get the \$400 million?

Mr. FRIEDMAN. Yes; one tranche was drawn down in 1976; the other tranche was drawn down this year.

In March or April they came up again and said: How about coming into the market again this year? We said: We are going through the same scenario. Why do you not go talk to the Fund first? Again we emphasized that if Peru approaches the banks without going to the Fund first, it will find that the banks have to make their own evaluations of Peru. If Peru goes to the Fund first, it will have established macroeconomic conditions. Peru can then come talk to the banks. A bank may well have lending criteria beyond and more stringent than those of the Fund.

They took that advice, and they went to the Fund. As is well known, they had negotiations with the Fund. Finally, their government was unable to adhere to the terms of the Fund, and negotiations broke down.

Mr. LEVINSON. Two Finance Ministers fell in the course of negotiations.

Mr. FRIEDMAN. That is correct.

They came back, and we spoke to them again. Some had said that the banks could never walk away from Peru, as they had such large outstandings in Peru. Peru is a prime example. Unlike Zaire, the magnitudes in Peru were large.

Mr. LEVINSON. \$3 billion.

Mr. FRIEDMAN. I am not sure of the numbers but they are large numbers.

Senator CHURCH. I just wanted to make this observation, and you can tell me if I am correct in it, and then we can conclude our hearing.

CONDITIONALITY OF THE PRIVATE BANKS

You gave us a very interesting account of how your bank managed its loan to Peru. What you have related is that private banks may have to lay down conditionality in effect, in order to justify further loans, enabling heavily indebted countries to repay earlier.

Mr. FRIEDMAN. That is a fair way of putting it. I should say one thing about that, however, although I do not want to seem to be quib-

bling. Peru was an exception to this, in that it involved spelling out conditions. In most cases, it takes the form of a country evaluation, in which a bank tells a country which approaches a bank for a loan it is sorry, but it does not regard the country as creditworthy. Then if nothing further happens, the bank and the country do not go on and discuss conditions.

Senator CHURCH. If you have \$3 billion invested in a country, you are not in a happy position of simply saying you are no longer creditworthy; you get no more money. Without more money, you do not get your previous loans repaid.

Mr. FRIEDMAN. Senator Church, the end to the story illustrates the answer. When we went back to Peru just a few weeks ago, we said to them: No matter how much we have invested, you do not send good money after bad.

If you have to default, that is your decision. If you do it, you do it. There will be, however, no money from the private banks unless you have a complete change in your economic program, that is, a program which has the endorsement of the Fund.

The mere fact that we have a substantial stake in Peru already is no reason to increase that stake in the face of an adverse outlook. Therefore, we told Peru you must change the outlook. That is our present position. We are waiting for that change. This is the way to solve this problem.

We did not tell them what to do. Rather, we told them that we are sorry. The country is simply not credit worthy, and a prudent bank in the face of these facts cannot increase its exposure. Therefore, we said that Peru would have, so to speak, to go back to the drawing board. We told them that when they are ready to talk to us about what they proposed to do to change our evaluations about their future, we would be very happy to sit down and talk to them.

I think that this is, in part, the answer to your last question, when we broached this whole problem of the interrelationship of the new debt and existing debt.

A GAME OF FINANCIAL CHICKEN

Senator CHURCH. It sounds to me as if there may come a time in connection with some of these countries where you are really engaged in a game of financial chicken. There is an interesting relationship between the private banks and the IMF, one that this committee is trying to get educated about, particularly if we consider the facility, and I think your testimony has been helpful in that regard.

There is no doubt at all that the existence of the IMF provides a very valuable tool in helping to effect corrections in the economic policies of debtor countries to make it possible for a further extension of credit to them.

Mr. FRIEDMAN. Yes; it does.

THE EFFECTIVENESS OF THE FUND

I would like to say that I hope that the Fund would, at some time, be sufficiently large and authoritative to have a similar influence on the credit worthiness of developed countries. I strongly support the view that you are expressing, and that your staff is expressing, that we are

going to have to solve some long-run structural problems if we are ever going to have real confidence in the future.

I look at the Fund as one of the instruments in dealing with this type of structural readjustment.

Senator CHURCH. I appreciate that comment. Since the Fund was originally created as the child creditor countries, I do not know whether it will grow large enough to turn around and influence the developed countries as well. I think maybe it is in its adolescence now. I do not know if it is large enough to face its parents and say, you behave too, but that remains to be seen.

Mr. FRIEDMAN. Mr. Chairman, I did not start out by thanking you very much for the opportunity to be here. I did want to put that in the record.

Senator CHURCH. You are the first witness, in my experience, who has put that into the record at the close of his testimony instead of the beginning.

Thank you very much.

[Thereupon, at 4:20 p.m. the subcommittee recessed, to reconvene at the call of the Chair.]

The first part of the document discusses the importance of maintaining accurate records of all transactions. It emphasizes that every entry should be supported by a valid receipt or invoice. This ensures transparency and allows for easy verification of the data.

In the second section, the author outlines the various methods used to collect and analyze the data. This includes both primary and secondary data collection techniques. The analysis focuses on identifying trends and patterns over time, which is crucial for making informed decisions.

The third part of the document provides a detailed breakdown of the results. It shows that there has been a significant increase in sales volume, particularly in the middle and lower income brackets. This suggests that the current marketing strategy is effective in reaching these target audiences.

Finally, the document concludes with several key recommendations. It suggests that the company should continue to invest in research and development to stay ahead of the competition. Additionally, it recommends a more targeted marketing approach to further optimize resource allocation.

APPENDIX

1917

PREPARED STATEMENTS SUBMITTED FOR THE RECORD

APPENDIX A

PREPARED STATEMENT OF HON. ANTHONY M. SOLOMON, UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS ON LEGISLATION TO AUTHORIZE U.S. PARTICIPATION IN THE IMF SUPPLEMENTARY FINANCING FACILITY, U.S. TREASURY

Mr. Chairman and Members of the Subcommittee: The legislation before you would authorize United States participation in the Supplementary Financing Facility of the International Monetary Fund. I am pleased to give you the Administration's views on why we strongly support this vitally important legislation, and ask that you report it favorably.

The international monetary system at present faces certain potentially serious problems. The Supplementary Financing Facility is needed, and urgently needed, to strengthen the International Monetary Fund, and to enable us to deal with these problems. The establishment of this facility will help to make sure that our international monetary system continues to function smoothly, and it will further in an important way our objectives of an open and liberal system of international trade and payments. United States participation is a prerequisite to the facility's entry into force, and I urge, on behalf of the Administration, that the Congress authorize that participation.

Much of the relative prosperity which the world has enjoyed over the past thirty years—in contrast to earlier decades—derives from the strength and effectiveness of our international monetary system, with the IMF as its principal instrument. That system has provided the framework for a growth in world trade and financial flows unthinkable at the time the IMF was established. No nation has benefited more than the United States.

Our foreign trade amounted to \$235 billion last year, nearly 15 percent of our gross national product. Our exports provide one out of every six manufacturing jobs. Essential imports are integrated into all phases of our economic life. Our currency is widely used internationally and widely held, and our capital markets channel vast sums to investment throughout the world. Our efforts to promote growth, reduce unemployment and curb inflation depend on an effective international monetary system. Other nations receive similar benefits.

The monetary sphere is one area in which international cooperation has operated with a high degree of success. We have on a number of occasions modified and adapted the system to meet new problems and new circumstances, most recently and most fundamentally in last year's Jamaica agreements. Similarly, we have progressively strengthened the IMF in its ability to fulfill its central role as referee, or keeper of the monetary "rules of the game," and as principal source of official balance-of-payments financing. The Supplementary Financing Facility is a further such step, an important step to meet a serious present need arising out of drastic changes in the pattern of international payments in recent years.

Since 1973, there have been international payments imbalances of unprecedented size resulting from the massive oil price increases, deep world recession and rapid inflation. This has placed serious strains on the system. With the recognition that these imbalances could not be eliminated in the short run, emphasis was placed on "financing" the deficits. Both official and private financing expanded sharply. The increase was spectacular. In the three years 1971 through 1973, the aggregate deficit of all nations in current account deficit averaged \$15 billion a year. In the three years 1974 through 1976, it was \$75 billion a year, a total of \$225 billion for the three years.

Nations borrowed very heavily in the years 1974 through 1976 to finance their large balance of payments deficits. The borrowing took many forms. While official financing through the IMF during this period was far above historic levels, it was the private markets that handled the bulk of the financing, accounting for about three-quarters of the total.

Such data as are available—admittedly incomplete—show a pattern of world payments in the period 1974 through 1976 roughly as follows:

The cumulative current account deficits financed equaled about \$225 billion or so (after the receipt of grant aid), representing the counterpart of the lendable surpluses of OPEC plus those of certain industrial countries registering surpluses during the period.

About \$15 billion of these deficits, or 7 percent of the total, was financed through the IMF, the bulk of it through the temporary "Oil Facility" and the "Compensatory Financing Facility," both of which provided financing largely on the basis of "need" with relatively little emphasis on "conditionality" or the adoption of corrective adjustment measures by the borrower.

About \$40 billion of the deficits, or 18 percent of the total, was financed through a variety of other official sources—development lending by industrial countries and OPEC, by the IBRD and regional development banks, and other sources.

The remaining current account deficits, some \$170 billion, plus about \$40 billion of debt repayments, were financed largely through market-oriented borrowing. Most of these funds were obtained through banks and securities markets. Some came from governments seeking investment outlets for their surpluses or as export financing.

Given the private market orientation of the world economy, it was natural that the bulk of this financing be handled by private rather than official channels. The private institutions were in a position to expand the level of their activity. Huge surpluses, by OPEC and other countries, of course, brought large deposits and placements to the banks and other financial intermediaries, and greatly expanded the loanable funds of those institutions. In addition, the period was one of rapid institutional expansion in the international banking system. Many institutions were competing eagerly for new customers, as they sought to establish themselves in new activities and new geographic areas, and endeavored to broaden their scope of operations so as to spread risks and diversify portfolios at a time when domestic loan demand was less buoyant than in immediately preceding years.

The question has been raised as to whether this rapid and unprecedented enlargement of lending activity and debt has reached a danger point for the monetary system—either in the sense that large numbers of countries have borrowed beyond their capacity to service debt, or in the sense that our banks and other institutions are overextended.

It is our considered judgment that the system as a whole is not in any such position of imminent danger, either as a result of excessive borrowing by large numbers of debtor nations or as a result of our financial institutions being overstretched.

There is a misconception that the increased borrowing is being undertaken largely by the non-oil exporting developing nations, and that if there is a danger point in the system, it is the ability of these nations to service their debts. At present, these developing nations—as a group—are not running the large deficits and are not the heavy borrowers. The aggregate current account deficit of the developing nations was large in the recession period 1974-75, but it has subsequently declined very considerably, and currently is no larger, adjusted for inflation, than their deficits prior to the oil price increase. After counting receipts of grant aid, the non-oil LDC's aggregate deficit is estimated for 1977 at about \$13 billion, or half the level of 1975. This group increased its reserves last year by \$11 billion, and registered a slightly higher economic growth rate than the industrial world. Of course, some developing nations are in difficulty—looking at the group as a whole can conceal important differences in individual countries. But it is largely the OECD countries—both the more developed and the non-industrial—that have accounted for the bulk of the deficits and the heavy borrowing.

But the fact that the system has—in the financing sense—worked well thus far is no cause for comfort or complacency. Success in the past is no guarantee that we are adequately armed for the period ahead. Let me comment on our expectations for the future and how the Supplementary Financing Facility fits into the picture.

Nations have approved the broad outlines of a balance-of-payments adjustment strategy. At the Manila IMF meeting last fall, it was agreed that:

Adjustment should be symmetrical, reducing both surpluses and deficits;

Countries in balance of payments difficulty should shift resources to the external sector and bring current account positions into line with sustainable capital inflows;

Countries in strong payments positions should maintain adequate demand, consistent with anti-inflationary policies;

Exchange rates should play their proper role in adjustment.

Looking ahead, it is nonetheless a safe prediction that large imbalances will continue for the next several years. On the surplus side, the present imbalances consist of two parts: the current account surpluses of several industrial countries—in particular Germany, Japan, Switzerland and the Netherlands; and more importantly, the surpluses of certain OPEC countries—mainly in the Persian Gulf area.

We expect a reduction in the surpluses of the major industrial countries, as these nations expand their economies in line with domestic needs and the agreed adjustment strategy. But we expect only a gradual decline in the OPEC surplus—which is the largest part of the imbalance—from the present level of about \$40 billion.

As is clearly pointed out in the Subcommittee's recent staff report, the OPEC surplus does not lend itself to abrupt correction. It is structural in nature. The energy needs of the oil importing nations cannot be suddenly and sharply cut back, if economic activity is to be maintained at acceptable levels—and adequate supplies from alternative sources do not at present exist. The reduction and elimination of OPEC surpluses through curtailment of oil imports will take a period of years. It is important—critically important—that the United States and other oil importing nations apply stringent measures to conserve energy use and expand energy production. President Carter's program will make a major contribution to an improved energy balance. But our program, and those of others, cannot yield major reductions in oil imports overnight.

Similarly, it is not realistic to expect, in the relatively small number of OPEC nations in which the surpluses are concentrated, too rapid an increase in purchases of foreign goods and services. A number of OPEC nations have, in fact, expanded rapidly their imports of development and consumption goods to the extent that their surpluses have virtually disappeared. But the remaining OPEC surpluses are concentrated in nations whose absorptive capacity for imports is quite limited.

Accordingly, it must be expected that large imbalances will continue at least for the next few years, while we work toward their elimination. In the meantime, our efforts must be directed toward assuring that the collective current account deficits are distributed, and to the extent possible reduced, so that the necessary borrowing is undertaken by those countries whose creditworthiness and economic strength are adequate to sustain the additional debt. By encouraging responsible adjustment measures in those countries experiencing severe domestic economic distortion, large payments deficits and serious financing problems, such deficits are reduced and shifted to a more sustainable worldwide pattern. The Supplementary Financing Facility is a major element of our strategy for fostering this needed adjustment, and helping to assure such a sustainable pattern of payments.

With the establishment of the Supplementary Financing Facility there will continue to be a large amount of borrowing—private as well as public. Concern has been expressed that continued borrowing in very large amounts, irrespective of who is borrowing or how the credit is used, constitutes a serious danger for the monetary system. I do not share that view. If the borrowed funds are properly used to support productive investment and to strengthen the borrower's current account position, the debt need not constitute a serious future burden, as shown by the experience of the United States in the last century and other countries at present. Excess savings in surplus OPEC countries can, in effect, finance investment in the oil importing countries by supplementing domestic savings. But the borrowed funds should be productively invested, in order to avoid servicing problems in the future.

This, then is the broad strategy within which the Supplementary Financing Facility fits—we aim for a sustainable pattern of payments in which the borrowing is undertaken by countries commensurate with their creditworthiness; we seek to assure that the borrowed funds are used to support sound and effective programs of stabilization and adjustment; and meanwhile we work toward elimination of the oil imbalance through energy programs and further development of the OPEC nations' capacity to import.

The Supplementary Financing Facility will thus help to assure that needed financing is available and that adjustment measures are adopted. Much adjustment remains to be done. Structural changes, domestic and external, must take place in many countries, often involving major alterations of traditional patterns of production and consumption. Such changes will not come easily and must take place over a number of years if satisfactory levels of growth and

employment—and an open system of trade and payments—are to be maintained. Substantial financing will continue to be needed by countries in deficit. And, in some countries, adjustment measures need to be introduced.

Clearly there are countries—certainly not a large number but a significant number—that have already reached or are approaching the limits of their ability to borrow or their prudence in doing so. These are countries that are beset by internal economic imbalances, that still face large payments deficits, where the need for corrective measures and internal and external adjustment is compelling.

Such countries, and others which may in future face similar difficulties, must be encouraged, and permitted, to adjust their economies in ways that are compatible with our liberal trade and payments objectives, in ways that avoid discrimination against others and disruption of the world economy. Our monetary system must foster sound adjustment, internationally responsible adjustment, with programs that develop underlying economic and financial stability in the countries undertaking adjustment measures, while avoiding recourse to trade and payments restrictions that are destructive of international prosperity. This economic and financial stability is a pre-requisite to sustainable expansion and high employment. A major function of the IMF is to induce such adjustment.

Given our expectations, it is essential that the resources of the IMF be adequate both to enable it to foster responsible adjustment policies by members facing severe payments difficulties, and also to provide confidence to the world community that it can cope with any potential problems that may arise.

Without the additional funds of the new facility, the IMF's resources may not be adequate to meet demands placed on it over the next several years. With relatively large use in the past three years, the IMF's usable resources are at present extremely low at about \$5 billion. These usable resources will be increased by about \$6 to \$7 billion with the coming into effect of the sixth quota review approved in 1976 and now being ratified, and about \$3 billion remains available under certain conditions through the General Arrangements to Borrow. Even with those additions, and the repayments which may be expected, the IMF's resources look sparse in a world in which total imports are running at an annual level of nearly a trillion dollars, and in which OPEC surpluses are likely to decline only gradually from the current \$40 billion annual level.

Against this background, the decision was taken to seek to establish the Supplementary Financing Facility, with financing of about \$10 billion to be provided initially by seven industrial nations and seven OPEC countries. The industrial countries would provide \$5.2 billion, of which the U.S. share—subject to Congressional authorization—would be SDR 1.45 billion (about \$1.7 billion) approximately 17 percent of the total. The OPEC members would provide about \$4.8 billion, or nearly half the total, with Saudi Arabia the largest single participant of either group at \$2.5 billion.

The terms relating to the provision of this financing to the IMF by the participants are presented in detail in the National Advisory Council Special Report on the Supplementary Financing Facility presented to the Congress with the legislation. Under the agreed terms, participation in the facility is advantageous to the United States and others providing the financing. In addition to furthering our interest in assuring a strong and smoothly functioning international monetary system, U.S. participation in the facility provides us with a strong, liquid and interest-earning monetary asset. Under the facility, the United States and other participants agree to provide currency to the IMF in exchange for a liquid claim on the IMF of equivalent value. These claims on the IMF, which can be drawn down any time there is a balance of payments need to do so, form part of our international reserve assets. The United States can also sell or transfer these assets to others by mutual agreement. Since, in exchange for any dollars we provide, we receive a fully liquid claim which can be drawn down any time we have a need to do so, there is no U.S. budget expenditure involved, but rather an exchange of one asset for another. This treatment is in keeping with the budget and accounting practices followed with respect to all U.S. transactions with the IMF.

The interest rate we receive from the IMF is linked to U.S. Treasury issues of comparable maturity, so that there is no net cost to the Treasury from our participation in the facility. As the drawings are repaid by the borrower, the IMF returns the dollars to the U.S., U.S. drawing rights on the IMF correspondingly are reduced, and the transaction is reversed.

This \$10 billion facility would be available to the IMF for a temporary period. Countries could apply within the next 2 to 3 years, and could draw down funds

over a period of 2 to 3 years, though the total period of disbursements could not exceed 5 years. It would be available for use by IMF members only under clearly defined criteria. Specifically, a member drawing under the facility:

Must have a balance of payments financing need that is large in relation to its IMF quota and exceeds the amount available to it under the IMF's regular policies.

Requires a period of adjustment that is longer than that provided for under regular IMF policies.

Must enter into a stand-by agreement with the IMF in which it undertakes to adopt corrective economic policy measures adequate to deal with its balance of payments problem.

The facility, in short, is designed to encourage those countries with particularly severe payments problems to adopt internationally responsible adjustment programs—and to avoid the unwelcome alternatives of resort to the controls; trade restrictions, and beggar-thy-neighbor policies which can be so harmful to world prosperity and so disruptive of our liberal trade and payments order. It will, in addition, by fostering a smoother, more effective process of international balance of payments adjustment, reinforce confidence in the international monetary system, and thus facilitate the flow of financing throughout the system. It is not a device for augmenting development assistance—the IMF provides only short to medium term balance of payments support. The member drawing on the facility receives more financing than is otherwise available from the IMF; a longer period of adjustment (a 2- to 3-year program as compared with the 1 year normally applicable in the IMF); and a longer period of repayment (3- to 7-year maturity, as compared with the IMF's normal 3- to 5-year maturity). Since interest on the financing provided to the Fund is market-related, the borrowing country would also pay a somewhat higher charge than for normal IMF drawings.

The facility is a cooperative venture, with the surplus countries of OPEC and the stronger industrial countries joining together to assure that the needed financing will be available. The agreement requires that before the facility can begin operations, participants must formally commit \$9 billion of the full \$10 billion, and the six largest participants must all formally commit themselves to participate. Thus action by the United States, and the Congress, is necessary before the facility can become a reality.

Let me address three questions which have been asked with respect to this new facility.

First, how can we be sure that the \$10 billion contemplated for the facility is adequate to do the job but not more than is needed?

Obviously it is a matter of judgment and no one can be absolutely sure. We cannot predict with certainty just which countries will have the particularly large needs for credit that make them eligible for this facility, along with the willingness to adopt the kind of adjustment programs associated with it. It is our judgment that this facility plus the amounts available to the IMF from other sources will enable it to provide financing over the next 2 or 3 years up to, say, a total of \$25 billion. This is above the levels of IMF financing of recent years; which were already relatively high. To assure confidence in the monetary system, it is vital that the IMF always be known to have adequate resources in reserve to meet whatever urgent problems may arise, even if it turns out that less than the full amount is actually drawn. Since no cash transaction occurs until a member country actually draws from the IMF, there is no interest or other cost whatever—to the IMF, or to the United States and other participants—for any portion of the facility not actually utilized for drawings.

A second question is will the facility serve to "bail out" private banks which have lent unwisely or excessively?

The answer is "no." The facility is not so designed and will not be so used. It will not bail out either countries or banks. It will encourage countries to initiate needed adjustment measure before their debts become too large to handle or credit is no longer available, and it will provide transitional financing while the measures take effect. It will help redistribute deficits to a more sustainable pattern, and improve nations' creditworthiness and confidence in the monetary system.

It is not a substitute for bank credit and will not take over the bank's regular lending activities. While IMF financing may in the period ahead account for a share of total balance of payments financing larger than the 7 percent it pro-

vided in 1974-76, it will remain small in comparison with the share channeled through private markets. In fact, the facility is expected to encourage banks to continue to expand their foreign lending rather than cut back, by promoting sound economic policies on the part of borrowers—and experience indicates that in fact the banks normally lend more to a country after it has entered into a stand-by agreement with the IMF. The banks will benefit from the new facility, but only indirectly—through the improved international environment, stronger monetary system and high levels of trade that will benefit all elements of the American economy.

A third question is why was the Supplementary Financing Facility established rather than the alternative of a permanent change in IMF quotas.

The answer is that this method was chosen for reasons of timing and practicality. A review of IMF quotas is under way, but with the complications of negotiations and ratification, it may not lead to actual quota increase for, say, two years or more. Hopefully the new facility can be put into operation at any early date, and cover the particular needs until a quota revision occurs. The facility is also more flexible than a quota increase, since it is not subject to the same quota constraints and can be used more selectively to meet the problems of countries with particularly large needs.

Mr. Chairman, the IMF is a valuable institution, in which all members contribute, financially and otherwise, to an effective international monetary system. It has a good record. The proposal for a Supplementary Financing Facility is a sensible and realistic way to strengthen it to meet present problems. The facility is equitable to all parties. It is needed, and needed soon. The Administration urges that the Committee report the proposed legislation favorably, and that the Congress enact it promptly.

I thank you.

PREPARED STATEMENT OF ALBERT FISHLOW

These hearings are opportune. They come at a time when the issue of developing country indebtedness is receding from public interest. The Wall Street Journal only last week quoted the IMF Annual Report as saying the "current-accounts deficit of the nonoil developing countries . . . is 'no longer a source of serious concern.'" That view, like the predictions of massive default that were current only a little while earlier, oversimplifies the reality.

OVERVIEW

That reality consists, in the first instance, of a total disbursed debt of developing countries at the end of the 1976 that has been estimated at about \$160 billion. This includes all liabilities, short and long-term, publicly guaranteed and not. On the other hand, the estimate excludes the liabilities of the Mediterranean group of more advanced developing countries. It is a debt that has grown considerably since the late 1960s; at the end of 1967 it amounted to not much more than \$30 billion.

Its increase has proceeded in two phases. In the first, before the oil crisis, there was the continuing finance of current account deficits accruing in the course of efforts to accelerate development. From the early 1970s onward, private loans increased in importance. One new source of resources came from international banks through the Euro-currency market. Thus, in 1970-73, private non-equity net flows to all developing countries amounted to more than a third of all capital inflow they received; the Euro-currency market alone amounted to 16 percent of all the resources received. By contrast, in 1964-66, total private loans amounted to only 18 percent of capital inflow.

The growth of private finance and the role of the banking sector, rather than direct investment or official development assistance, was given a decisive impulse by the dramatic change in international markets brought on by the increase in petroleum prices. Through 1973 the heightened capital inflows were responsive to the success of middle income countries like Brazil, Mexico, and Korea in sustaining high rates of economic growth and export earnings. Thereafter they were more influenced by the extraordinary new supply of oil deposits that were the cash counterpart of the oil price increase; the gathering recession in the industrialized countries and the consequent reduction of private sector loan demand;

and the much larger current account deficits run by the developing countries as a combination of both the foregoing circumstances.

In the period 1974-76 the current account deficits of the developing countries amounted to a staggering \$90 billion before official transfers. In the absence of the oil crisis, development needs might have meant deficits of \$25 to \$30 billion. The rise in petroleum prices, narrowly construed, accounted for perhaps half of the increment through increased import requirements. The indirect contribution through higher prices for other imports, and reduced export markets in the industrialized countries, accounts for the rest. In the largest sense, these deficits became the counterpart of the surpluses accumulated by the oil-exporting countries. The recession in the industrialized countries converted their initially large 1974 current account deficits into surplus in 1975 and modest deficit in 1976.

The private financial sector was the principal intermediary that equated the new surpluses and deficits. It did so far more effectively than many had presumed possible. The role they played in 1974 was primarily ordained by the massive inflow of short-term deposits held by the OPEC countries, estimated at well over \$20 billion. And their customers included not merely developing countries but also the more developed. Thereafter, however, the explanation turns more upon the continuing demand for finance of the developing countries, and the reduced demand for loans internally. The deposit of OPEC surpluses was no longer the impelling factor: in 1976 the Bank of International Settlements has estimated that the bank deposits of oil-exporting countries increased by some \$12 billion, while new lending to all borrowers was \$70 billion. Those additional resources came primarily from private deposits in the developed countries, as well as increased deposits of developing countries themselves. The latter are the counterpart to the \$11 billion increase in reserves accumulated by them in 1976. Their capital inflows last year much more than covered their deficit of \$25 billion, down considerably from the previous year.

United States banks and branches shared prominently in the flows to developing countries. The lifting of balance of payments limitations meant that home offices and not merely branches participated. Since 1974, together they have accounted for around 60 percent of the loan volume to developing countries. It has been a profitable development: the international portfolio has generated a higher yield than the domestic.

The earlier tendencies toward private finance, and commercial bank participation, have thus been much magnified since 1973. Private bank lending now surpasses official development assistance as well as direct investment abroad. It is this transformation that gives content to two distinct aspects of the debt crisis.

The first is the insufficiency of capital for the lowest income countries. Banks have not been indiscriminate in their selection of clients. Their lending, as is appropriate, has been concentrated in the upper middle income countries. Of the \$89.1 billion estimated by the BIS to be lent by the international banks to developing countries at the end of 1976, \$39.1 billion was accounted for by only two countries, Brazil and Mexico. In 1976 these two increased their net indebtedness by \$7.0 billion, or \$1.5 billion more than the net increase for all non-oil exporting developing countries. The Western Hemisphere is the only region with a significant debtor position vis-a-vis the international banks; for all others, deposits virtually offset outstanding loans.

Official lending to the poorest countries, and their access to the IMF oil facility, has not kept pace with the private flows. Yet the Fourth World already had been falling behind in income growth even while many middle income countries had been accelerating in the late 1960s and early 1970s. The debt service requirements of these countries remain modest percentages of their gross product because of the considerable grant element in the official loans initially extended to them. Nonetheless they have become an increasing charge on stagnant exports, and limit the possibilities for import of needed food and capital goods. The plight of these low income countries is a side of the debt problem that should not be ignored, even though its effect on international capital markets is minimal.

On the other side are a small number of largely middle income countries that have been recipients of abundant capital. Some face relatively less difficulty. They absorbed the impact of the oil price rise immediately, experienced slower import and product growth, and have resumed more rapid export growth with the recovery in world trade. Others face more. The debt problem for them consists of

mounting interest and amortization payments that are a certain charge against their foreign exchange receipts. The commercial terms on which the debt has been contracted mean larger and more immediate outflows. These are countries that contributed significantly to the aggregate current account deficits experienced in recent years—both because their imports increased sharply and their export growth was interrupted. The buoyant markets for sugar, copper, fishmeal, rice, soybeans, wheat, etc. that led to unprecedented price increases have not returned. Internal pressures to sustain high rates of growth despite unfavorable external circumstances meant increased resort to debt to finance it.

The problem for most of these countries is not the imminence of default so much as it is the burden of internal adjustment, a burden whose magnitude is critically dependent upon the continuing availability of external finance as well as rapid growth of world trade. Because rising service payments mean less foreign exchange for imports, total domestic expenditure must be curtailed; and because imports themselves contribute to capital formation and export potential, not merely real income but also longer range growth prospects are adversely affected.

Some recent analyses have stressed a likely trend toward reduced current account deficits in the next few years as marking an end to the debt problem. That is a partial view. It ignores how much of the deficit will go for factor payments abroad rather than for imports of needed goods and services. It fails to specify that because of amortization offsets, continued very large gross capital outflows will remain necessary. It gives insufficient attention to whether the adjustment occurs through reduced growth of the debtor countries or resumption of rapid growth in the industrialized countries and how the former is to be accomplished. It does not confront the reluctance of the industrialized countries to accept current account deficits as the needed offset to oil exporting country surpluses.

International financial markets have reacted well thus far to the oil exporting country surpluses. Whether they will continue to do so is less clear. The great concentration of bank lending not only has deprived the poorer countries; it makes individual country evaluations by the private sector critical to their continuing development prospects. Private banks have de facto become development banks of a special kind.

I wish to give more concrete basis for my concern by focusing on the debt problem of the Western Hemisphere. As a region it accounts for perhaps half of the gross debt, and even a larger share of the net debt after offsetting reserves have been subtracted. Commercial bank credits are even more concentrated in Latin America. Nor, need I add, that the repercussions for United States foreign policy are greater and more immediate.

THE WESTERN HEMISPHERE

The Latin American experience with finance in the post-war period has three dimensions that should be noted. One is the relatively limited access to foreign capital until the end of the 1960s and beginning of the 1970s. The current account deficit as a percentage of gross domestic product hovered about 1.5 percent; in the early 1970s it first exceeded 2 percent, and since 1974 has more than doubled. The petroleum crisis converted an attractive option that many of the larger countries had taken up, into a necessity. Second is the fact that problems of external finance in the region antedate the present. Service payments—inclusive of profit remittances—have represented almost a third of export proceeds since the early 1960s. Many hemispheric countries at that time experienced repayment problems precisely because the low level of external finance permitted a small margin for net resource transfer. What averted the gloomy predictions then prevalent was an acceleration in exports, but also external flows of magnitude that was unanticipated. The net transfers of \$476 million a year in the late 1960s were multiplied 8-fold in the early 1970s even before the extraordinary transfers in 1974-76. Third is the expanding role of the private banking sector in making such flows available. A conservative estimate is that well over half the debt is now held in banks. That has meant higher interest rates, shorter maturities, and greater vulnerability to conditions in international capital markets. When other demands have dominated the Latin American countries have faced higher rates and crowding out; when funds are abundant, the excess is urged upon borrowers.

TABLE 1.—CURRENT DEBT SITUATION IN LATIN AMERICA

[In billions of dollars]

	Publicly guaranteed debt	Total debt	Bank debt	Net total debt
Latin America.....	49.0	74.0-79.0	50.0-55.0	60.0
Brazil.....	15.0	26.0-30.0	21.0	21.0
Mexico.....	14.0	18.0-24.0	18.0	19.0
Peru.....	3.3	4.5	2.8	4.2

Sources:

Publicly guaranteed debt:

Latin America: InterAmerican Development Bank, "Latin America's External Indebtedness: Current Situation and Prospects" (May 1977).

Brazil, Mexico, Peru: H. van B. Cleveland and W. H. Bruce Brittain, "Are the LDC's in Over Their Heads?" "Foreign Affairs" (July 1977), 734.

Total debt:

Latin America: Albert Fishlow, "Debt, Growth and Hemispheric Relations: Latin American Prospects in the 1980's," mimeo. (August 1977), ECLA, "Economic Survey of Latin America, 1976" (June 1977).

Brazil, Mexico, Peru: ECLA, "Economic Survey," Irving S. Friedman, "The Emerging Role of Private Banks in the Developing World" (Citicorp, 1977).

Bank debt:

Latin America: ECLA, "Survey," Bank for International Settlements, "47th Annual Report" (June 1977), 112.

Brazil, Mexico, Peru: BIS, "Report."

Net total debt: Gross debt less international reserves from IMF, "International Financial Statistics."

Table 1 outlines the present debt situation of the region as a whole and three of its principal debtors. Brazil, Mexico and Peru together account for almost three-fourths the net debt after reserves have been taken into account. How well that burden can be shouldered over the intermediate term cannot be decided by calculating debt service ratios, or by estimating future current account deficits in isolation, or even by detailed projections of amortization and interest payments. Rather it depends upon such determinants of economic growth and trade as domestic savings capacity, import needs, export growth, the capital-output ratio, and the availability and terms of capital inflow. Simple aggregate economic models can be constructed incorporating such factors. They yield useful insights into the nature of the debt problems confronting these countries. It should be stressed, however, that they do not pretend to predict; rather, they indicate tendencies latent in the economic structure, and point to the need for changes in it.

Before presenting the qualitative conclusions derived from such exercises that I have reported on in detail elsewhere, it is useful to specify in more detail here how the debt of each of these countries has evolved in recent years. Those circumstances go far to explain why their future perspectives differ.

Brazil experienced very rapid and diversified growth of exports in the late 1960s and early 1970s. The volume expanded slightly more rapidly than product, and was augmented by prices that rose almost 50 percent between 1969 and 1973. These improved terms of trade, but much more, abundant foreign finance, led imports to increase more than twice as rapidly as gross product. The oil crisis intensified internal disequilibria that the very rapid growth from 1968 to 1973 had already begun to create. A current account imbalance of more than \$7 billion in 1974 was only partly explained by increased petroleum prices; about half came about from overvaluation of the exchange rate and continued rapid growth. Since 1974 imports have been held virtually constant in value terms, and have declined in real terms. Impressive efforts have been made to sustain real growth, nonetheless, and have contributed to a resurgence of domestic inflation.

Current account deficits have remained large despite growing exports as profit remittances and interest represent a progressively larger obligation. The ratio of the net debt to total product stands at about 20 percent of total product, having risen from 9 percent at the end of 1973. Service payments, including profits, absorbed 43 percent of export earnings in 1976, up from the 37 percent in 1973. To finance them the debt has more than doubled since 1973. Capital inflows have been continuously available, although at times at higher interest rates, and Brazil has even managed to restore the reserves lost in 1974 and 1975. It has been a classic case of debt-led development that thus far has succeeded.

Peru is a different story. While the military government has succeeded since 1968 in achieving a higher rate of growth, largely in the industrial sector, it has done so through reduced international trade, and not by opening the economy. The model was one of import substitution, and experimentation designed to improve the highly unequal distribution of income and wealth in the society. The doubling of export prices in 1973 and 1974 meant improved terms of trade despite the oil crisis. Peru was not a large petroleum importer in any event, and at that time believed it was the possessor of large reserves in the Amazon, large enough to justify construction of a billion dollar pipeline to the coast. That expectation, and the rise in export prices led to relatively easy access to capital market in 1973 and 1974, and unprecedented increases in imports. In 1975 and 1976 debt already became more difficult to contract even as it became more necessary to meet foreign exchange needs. Import growth slowed in 1975 and actually became negative in 1976, as exports stagnated. The rise in gross product likewise slackened, and reserves have virtually been exhausted.

In the last two years the burden of the debt has become apparent. In the net terms it stands at more than a third of gross product, and absorbs 44 percent of foreign exchange earnings—both up considerably from their 1974 levels. Unlike Brazil, however, the capital stringency confronting Peru makes these magnitudes an unhappy reminder of how vulnerable one can become by resorting to debt finance in an uncertain world.

The case of Mexico is yet another variant. It had long enjoyed one of the highest and most stable economic growth rates among the developing countries. It had benefited from its proximity to the United States in deriving significant revenues from tourism as well as capital inflow. Even before the recent more extensive finds, its oil production insulated it from the rise in oil prices. The rapid increase in debt in recent years derived from more fundamental disequilibria: a slowing rate of growth in the agricultural sector, increasing public sector deficits and internal inflation, faltering private investment, all contributed to an overvalued peso that left Mexican exports uncompetitive and increased demand for imports.

Accumulating debt could not resolve these problems in the short run and merely postponed the inevitable need to come to grips with them. Increasing capital flight in 1976 forced the government's hand and provoked the devaluation at the end of August. It did not succeed in restoring the former economic model, as it could not be expected to; overvaluation was the symptom, not the underlying cause of Mexican difficulties. Indeed in the short run, devaluation fed internal inflation, and dampened private investment. Yet the longer run prospects could not help but be favorably influenced by PEMEX plans to accelerate petroleum exports in the next several years. That puts into a very different perspective the current ratio of service payments to exports of about 39 percent, a level that has been approximated in the last few years.

Indeed, the intermediate term projections for Mexico show that a continuing 10 percent rate of growth of exports is consistent with a 7.3 percent rate of product growth while permitting that service ratio to fall by a fifth. Imports can even be allowed a rising participation in product. (That presumes world inflation of 5 percent that of course contributes to a lesser debt burden; at a 0 inflation rate, the ratio actually rises somewhat.) A rate of 12 percent is actually more likely if current petroleum plans are fulfilled. In those circumstances the current account deficit turns a surplus within 10 years, and the service ratio and the ratio of debt to GDP halve. What must be stressed is that these optimistic projections presume continuing access to debt. At the lower export rate, the debt triples; at the higher, it doubles. Limitations on loans can be directly counterproductive by depriving Mexico of the imports necessary for capital investment and growth. Constant gross loans imply smaller net resource transfers that succeed in more immediate improvement in the current account deficit, but at the needless expense of economic growth. A second principal conclusion is the sensitivity of the debt requirements to export growth: small differences translate into large effects on the size of the terminal debt.

Peru has no such bonanza. Export rates will be sensitive to favorable commodity prices as much as large volume increases. Past experience gives little basis for supposing that a real trend rate greater than 7 percent is feasible. In the absence of terms of trade improvements, and even with declining import participation in product and growth of only 5 percent, the current accounts deficit remains at high levels at the end of the period. Debt would more than triple,

setting up still further obligations. Rather than a debt-led model of growth, it more resembles a debt trap.

Only the prospect of high and sustained export growth can justify levels of debt of the Peruvian magnitude. Where realization of those prospects are dependent upon external circumstances as much as internal transformation, the risks are considerable. Recovery of copper prices can, of course, dramatically improve matters. But pending such a change, which does not seem immediate, some means of reducing the present high charges on exports would seem to make sense.

Comparable calculations for Brazil make evident its intermediate position. Its possibilities are less certain because its export prospects are not as clearly favorable as the Mexican; the recent rise in coffee prices is a poor and temporary substitute for petroleum. On the other side, Brazil will remain a significant oil importer over the intermediate term. This means that it will require continuing export growth at high levels, increased national savings, a systematic effort to assure that imports grow less rapidly than income, and further large capital inflows in order to permit product to expand at rates of 7-8 percent. Illustratively, an export growth rate of 10 percent will lead to gradually reduced deficits over the period, a constant ratio of imports to product, while still permitting income to increase by 7.2 percent. But it requires for its achievement continuing accumulation of debt—a tripling over the period. More intensive efforts to restrain imports can of course lessen the need for loans. But one must be careful not to impose an external stringency that is counter-productive, and prevents the transformation needed to accelerate exports.

While I have thus far emphasized the differences in their situations and perspectives, it is useful also to stress the common factors that emerge from the preceding analysis, and their implications. For all three countries, despite the varying particulars of their accumulation of debt, it was the recession in the industrial countries and slowing export earnings that made apparent their vulnerability. For all three, as well, it is high rates of export growth that must provide a way out of the problem. More nationalist, inward-looking development has considerable rhetorical appeal. The reality is that any successful policy must aggressively stimulate exports as well. That in turn means controls over domestic expenditures, and restraint on consumption. But internal austerity, in the absence of favorable world trade conditions, will come to no avail. The other side of the debt coin is the access to markets.

Hastening the adjustment process excessively by curtailing external credit too severely, moreover, will result in considerable and unnecessary social cost. In all three countries increasing debt—or debt relief—is required to underwrite a feasible adjustment path. That is one of the limitations of present international financial markets dominated by private rather than official loans. Banking competition has a tendency to provide excessive credit when it is unnecessary, but insufficient resources—because of the risks—when it is. Price does not play much of a rationing role. Countries do have some countervailing power in increasing their credits, but only in extreme circumstances: banks do prefer to be repaid nominally—even with their own loans.

The question is not academic. Peru and Mexico both have dealt with the IMF and the private banks within the last year. Conditions for the latter have proved much less demanding, by reason of the potential for petroleum exports and the favorable performance of President Lopez Portillo. The private market is even ready to provide more funds than the IMF would like. Arrangements with Peru have proved more difficult and more novel. There was initially a direct agreement with the commercial banks that involved them deeply in monitoring and determining internal policy. That has broken down, and the IMF has again been drawn into the picture while private discussions continue. Since private loans are so large, no agreement that is not ratified by the international banks can be effective. There is no great tolerance for social experimentation and heterodoxy among private bankers, nor can they afford long time horizons. This will not lead to the design of optimal adjustment plans. The higher interest rates received by private banks would seem to justify their accepting a more flexible, and longer term adjustment path—particularly in the absence of good export prospects. What are risk premia for? The present situation gives a great weight to their preferences.

Over the intermediate run, there is the further possibility that recovery of investment in the developed countries will absorb much of the surplus that is directed abroad. To some degree there will be the offset of increased exports, but there remains the vulnerability of being a secondary, rather than primary borrower. Again private and social criteria do not coincide.

Another set of potential problems is posed by the policies of import substitution that are indicated, at least for Brazil and Peru. It will not be easy to accomplish without larger capital outlays and possible domestic inefficiencies. It may also require attraction of foreign capital and technology through inducements that set up later resentments and reactions. Beyond these difficult questions, there is the impact of import restraint upon external suppliers. Heightened tariffs, other limitations, and even possible preferences to regional sources, almost necessarily will continue to be necessary. The United States has not always proved itself sympathetic. During 1975, while Brazil was seeking to reduce its record \$6 billion trade deficit, the Commerce Department continued to complain that tariff levels prevented U.S. exports.

A final point relates to the bias debtor countries have for more rapid world inflation. Borrowing now for repayment later in depreciated currency imposes a much smaller real burden. Crudely speaking, for Latin America as a whole, each percentage point of inflation translates into a .1 percent increase in the annual growth rate of product for the same inflow of external resources. (The effect is a diminishing one, since with high rates of inflation the current requirements come to be even larger.)

Such an interest, and even more so an inflationary environment in which raw materials prices rise relatively to those of industrial products, place Latin America in direct opposition to the contrary efforts of the industrialized countries. It has not been a source of conflict yet. But if decelerating inflation is accompanied by high interest rates, and sluggish markets for exports, the situation could change.

POLICIES

I have sought to emphasize that the question of developing country indebtedness is intimately linked to the whole panoply of economic issues that make up the North-South agenda: trade, foreign investment, the structure of the international monetary system, commodity prices, the poverty of the Fourth World, etc. Partial solutions that focus only on international credit markets do not do the problem justice. Nor does a stress upon economics alone. The dislocations of even a minimal cost internal austerity program can have significant political repercussions; the severity of the terms, and the availability of generous external resources or not, have a direct bearing on the stability of regimes.

In closing, however, I will confine myself to brief remarks on those credit markets because they have such direct influence. The immediate issue is to restore a better balance to development finance. However positive the role of commercial banks in intermediating the oil-exporting country surpluses in the last few years, it should not persist. It has led to a distorted and excessively concentrated allocation of resources; it has led to a predominance of shorter-term lending that is inadequate to the needs of the developing countries; it has led to a potential, and occasionally realized, private involvement in national policymaking that is inappropriate.

Restoration of balance means a greater participation for official institutions. The proposed new IMF supplementary financing facility is a step in the right direction, particularly its extended repayment period. It will provide the Fund with resources that are necessary if it is to be able to respond to the much increased global demands for credit. It is only a partial step. Some effort must also be made to increase official, longer term lending and to assure that development objectives are not ignored.

I have proposed that methods be found to channel private commercial bank deposits to the multilateral, official banks. In particular I have suggested a swap of developing country loans currently held by the private banks for the bonds of the international institutions. That would facilitate dealing with the debt crisis in the short-run, by substituting a larger official presence. In the longer-run the official banks would continue to have the expanded resources to lend since they would be offering the commercial banks their run bonds of longer maturity.

That, and the fact that the official banks could choose part of the portfolio, would assure that the arrangement was not a mere bail-out of the commercial banks.

In the third instance, an expansion of the Import-Export Bank and a larger bilateral official participation in international credit markets is indicated. That institution itself should be better integrated into our overall foreign economic policy.

Finally, it is inevitable in the next several years that there be much closer cooperation between the private banks and official agencies in making new commitments. Private competition works imperfectly in the allocation of international credit. We have the luxury of having weathered the first impact of the oil surpluses with less damage than many feared. That time must be used effectively to devise new forms of intermediation appropriate to the changed circumstances.

PREPARED STATEMENT OF RICHARD N. COOPER, UNDER SECRETARY FOR
ECONOMIC AFFAIRS, DEPARTMENT OF STATE

Mr. Chairman: I am pleased to have this opportunity to appear before this subcommittee to discuss issues related to United States participation in the Supplementary Financing Facility (SFF) of the International Monetary Fund (IMF). I consider the Supplementary Facility to have major significance for foreign policy, and believe it will make an important contribution to international stability by providing countries faced with the need for restructuring their economies with adequate financial support and with appropriate terms and conditions.

I would like to take this opportunity to make some observations on recent developments in the world economy, most particularly, the buildup of external debt and the large imbalances which now characterize international payments. I will also examine the economic outlook for the period ahead, and analyze the role of the Supplementary Financing Facility in meeting the financial needs of countries which are still adjusting to the economic shocks of the recent past.

Finally, I would like to emphasize the importance of the facility in demonstrating our commitment to international cooperation and our resolve to sustain the international economic system from which we as a nation gain so much both as a market for our products and as a source of raw materials, energy, and other goods and services.

IMPACT OF RECENT EVENTS ON BALANCE OF PAYMENTS

Countries have traditionally relied on external borrowing to sustain imports of goods and services which exceed their export earnings. An accumulation of debt means that a country is experiencing an inward flow of economic resources. Such a flow enables a country to invest more than its own current savings and is thus advantageous for countries desiring to accelerate or sustain economic growth. There is nothing wrong with debt in itself.

Historically debt has been an integral component of world economic development. External borrowings have, for example, made major contributions to the development of the United States during the 19th century, and to the relatively more recent economic progress of the developing world. In other words, for countries which are making productive use of capital, the concept of external borrowing has long been considered both normal and responsible.

The oil price rise, coupled with world recession, has added a new dimension to the debt situation. In the three year period 1974-76, the combined current account surplus of OPEC nations approximated \$140 billion. (By way of contrast, their surplus for the seven prior years had totaled only about \$15 billion.) Since these surpluses inevitably generated a corresponding deficit in non-OPEC countries, balance of payments management for most oil-importing countries became very difficult.

The table from the 1977 Annual Report of the IMF shows clearly the impact on world current payments of the large increase in oil prices in 1974 which threw most oil-consuming countries into deficit; of the world recession in 1975, which shifted that deficit even more onto developing countries; and of the subsequent gradual world recovery which had reduced the deficit of developing countries and eliminated the aggregate surplus of the industrial countries.

GLOBAL STRUCTURE OF CURRENT ACCOUNT BALANCES¹

[In billions of U.S. dollars]

Groupings	1967-72 average	1973	1974	1975	1976	1977 projec- tions	1967-72 average rescaled to 1977 prices and levels of real output ²
Major oil exporting countries.....	0.7	6	67	35	41	37	3
Industrial countries.....	10.2	12	-10	19	-1	-1	31
Other nonoil countries:							
More developed.....	-1.7	1	-14	-15	-14	-12	-6
Less developed.....	-8.1	-11	-30	-38	-26	-25	-28
Total ³	1.1	8	14			-1	

¹ On goods, services, and private transfers.² Scale factors for prices are based on a general index of world trade prices; scale factors for growth are based on average rates of increase in real GNP (or GDP) in each of the respective groups of countries.³ Reflects errors, omissions, and asymmetries in reported balance of payments statistics, plus balance of listed groups with other countries.⁴ In rescaled version of 1967-72 average, this residual figure is primarily a reflection of asymmetries in the treatment of listed groups, and thus does not lend itself to meaningful interpretation.

Sources: Data reported to the International Monetary Fund and Fund staff estimates.

It would have been impossible for oil importing countries to eliminate these deficits quickly without introducing stringent austerity programs causing massive dislocations in their economies and major hardships for their citizens. In addition to jeopardizing the political stability of a number of countries in both the developed and developing world, such austerity programs would have brought an abrupt curtailment of economic growth in deficit countries. This would have greatly exacerbated the world economic recession that began in late 1973 by collapsing export markets through a sharp reduction in demand. Instead, policy makers chose, and I believe correctly, to finance the large energy deficits in order to lengthen the domestic economic adjustment process. This route has allowed us to maintain a functioning international economic system while preserving the domestic political and social stability of the deficit countries.

It may be of value to explain at this point that the lion's share of the surplus funds were deposited in the world banking system. These funds were drawn from economies on a worldwide scale proportionate to oil imports but were deposited essentially in the major banks of the world with headquarters or branches in New York and London. The private banking system had both the cash deposits placed by the oil surplus countries and the institutional capability to lend the funds. The banks have, therefore, played two critical roles. They have recycled the surpluses back into the financial system and they have redistributed these funds to deficit countries so that the adjustment process could be carried out more slowly.

From the rough data which are available, we can reconstruct how countries carried out this financing. During the 1974 through 1976 period, the total current account deficits financed were about \$225 billion. Fully three-fourths of this amount, some \$170 billion, plus about \$40 billion for the repayment of outstanding external debt, was obtained through borrowing from private banks and securities markets. An additional \$40 billion, or about 18 percent of the total, was obtained primarily by less developed nations from official sources such as foreign assistance loans, and from loans by the IBRD, regional development banks, and other intergovernmental sources. (Foreign assistance grants are already entered in the current account position.) The remaining \$15 billion, or about 7 percent of the total financing, was obtained through the International Monetary Fund, principally from the IMF's Oil Facility and Compensatory Financing Facility.

DEBT SERVICING

In assessing the current debt situation, one must give careful consideration to the debt servicing capacity of individual debtor countries. Although the problem, as always, requires our attention, there is little likelihood of a general debt crisis. As in the past, acute debt servicing problems are expected to be restricted

to a few countries, with individual problems, which require country-specific solutions.

In each case we should begin by recalling that a rising level of indebtedness does not by itself pose the threat of major debt servicing problems. The nominal increases in debt that have occurred appear far less dramatic when one allows both for the growth of real output and trade that has taken place in the world economy and for the inflation that has occurred.

Moreover, aggregate debt statistics can be misleading in that they obscure the diversity of conditions in different countries, especially the disparities in their capacities both to earn foreign exchange and to manage their debt effectively. It is important to recognize that external debt is distributed broadly in line with debt servicing capacity. For example, the bulk of existing private debt is concentrated in developed countries and a dozen or so rapidly growing developing countries with relatively high per capita incomes and diversified economies. Most of the new loans to the poorer countries, in contrast, have been intergovernmental and have been highly concessional in nature.

The ratio of a country's debt service payments to its annual exports of goods and services has often been used as a rough indicator of a country's debt burden. Its main value is as a guide to the short-run availability of foreign exchange to purchase the necessary goods to keep the economy growing and still service the principal and interest payments on its foreign debt. The higher the ratio, that is the larger the percentage of available foreign exchange needed to service the foreign debt, the greater the risk that payments on the debt could not be made. The debt service ratio at a particular time does not, however, record such key factors as the maturity structure of a country's debt or the cyclical variability of its export earnings or import costs.

The aggregate debt service ratio of all non-oil exporting developing countries was estimated at about 16 percent in 1973. It declined to 13 percent in 1974, largely as a result of an upsurge in commodity export prices and volume, and then rose to 14 percent in 1975, and to roughly 16 percent again in 1976. The ratio may increase moderately over the next few years. Since most industrial countries are relatively recent participants in large scale borrowing, and tend to have well developed export sectors, their debt service ratios—averaging less than 10 percent—are significantly lower than those of the developing world.

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Aggregate data, as I have already noted, disguise wide variations in individual country behavior. Several countries maintain debt service ratios considerably higher than the average. A number of important Latin American countries, for example, had 1976 debt service ratios in the 25 to 45 percent range. I emphasize, however, that the debt service ratio cannot be used independently as an accurate guide to debt servicing prospects. Other factors such as a country's growth and export potential must also be considered. This is the reason why the relatively more advanced developing countries tend to have the highest debt service ratios, yet still retain creditworthiness, while the poorer developing countries—with low debt service ratios—are generally unable to borrow in commercial markets.

PROSPECTS FOR THE OPEC SURPLUS

The debt servicing prospects of individual countries are of course inextricably tied to the outlook for the world financial system as a whole. The ability of the world economy to deal with large payments imbalances is of particular importance.

Although the current account surpluses of the OPEC countries have declined from their 1974 peak, they are still very large. Since it will take time both to raise their absorptive capacity for imports and to develop energy production and conservation in the rest of the world, it appears that the OPEC countries will in the aggregate register large payments surpluses for some time to come.

From the data available to us it seems clear that the OPEC surplus is likely to persist for a number of years ahead even though it may gradually decline from its current level of \$40 billion. This is not a prospect we view with equanimity and we take every opportunity to point out to the OPEC countries the dangers to world stability that continued oil price increases pose.

We are also making efforts to reduce the dependence of the U.S. economy on imported oil. The President's energy program is especially geared to an improved energy balance. Under his program, 1985 oil imports would be about 4.5 million barrels a day less than what would occur in the absence of the National Energy Plan. The significance of these figures is highlighted by the fact that the 8.5 million barrel a day import rate of 1977 will result in import payments of about \$45 billion.

The emergence of the OPEC countries as the major surplus group has been accompanied by the disappearance of the formerly large current account surpluses of the industrial countries. The present OPEC surplus is, moreover, only moderately larger than the current account surpluses of the industrial countries during the 1967-72 period, if these surpluses are rescaled to 1977 prices and 1977 levels of real output. (See the previous table.)

Since most of the financial surplus accruing to OPEC countries are, in effect, offset by the elimination of the former aggregate payments surplus of the industrial countries, the global level of international savings available for foreign investment is not significantly different from pre-1974 experience. The locus of those savings has merely shifted to certain OPEC countries. While the OPEC surplus certainly poses serious adjustment problems, it should not therefore in itself constitute an unmanageable impediment to world economic growth, if we assume that the OPEC countries have the same motives to invest abroad that the industrial countries had in the earlier period. Because the OPEC countries have little experience in foreign investment, they have so far relied on the United States and Euro-currency markets to intermediate their foreign lending.

This means that the critical problem for the non-OPEC countries is the way in which the deficits which correspond to the OPEC surplus are shared, and the methods by which they are financed. In this context, it is highly important to insure a distribution of the deficits geared to the underlying productive potential of individual countries and their ability to sustain additional debt.

SHARING PAYMENTS DEFICITS

The task of effecting a sustainable sharing of deficits among non-OPEC countries has been complicated by the suddenness of recent events, and by the great diversity in the economic situations of oil importing countries. A few countries have maintained strong payments positions, while other deficit countries have adopted policies which are bringing their balance of payments into a sustainable pattern. In other countries, however, stabilization programs have achieved only limited progress to date and additional time is necessary to restore equilibrium. There are still other countries which face large payments deficits but have only begun to develop adjustment policies. Some of the most difficult adjustment problems are found in industrial democracies. In all areas of the world there are countries where economic or political constraints require a longer horizon for economic adjustment than would have been the case for less serious disturbances.

Among the deficit countries requiring further adjustment, some appear to be fully capable of sustaining increased private borrowing. But there are other countries which already have had or will have difficulty in attracting sufficient private funds over the next few years. If adequate private financing is not available to the countries which need it, they will be forced to adopt restrictive trade policies in an attempt to ration the foreign exchange available to them. In today's interdependent world, the adoption of such policies, particularly because it could lead to retaliatory policies or even emulation by other countries, could have disastrous worldwide repercussions. The "beggar thy neighbor policies" adopted in the depression of the 1930's stand as a continuing lesson of the crippling affects of such policies on the world economy.

To ensure that our system is able to continue functioning effectively, deficit countries must be given both an incentive and an opportunity to adjust their economies at a pace consistent with the realities of their social, political, and economic situation. The availability of official external financing sufficient to support required adjustment is therefore of key importance for the international monetary and trade system, even though we fully expect private capital markets to continue providing preponderant portions of the necessary financing.

THE ROLE FOR THE SUPPLEMENTARY FINANCING FACILITY

The International Monetary Fund is the principal source of official balance of payments financing in the international monetary system. This financing provides members with an opportunity to devise policies to correct maladjustments in their balance of payments and to do so without resort to protectionist trade measures or predatory currency devaluation. Since 1973, extensive use of IMF credit has greatly eased adjustment problems. At the same time, the IMF's greatly increased activity has caused a depletion of its available resources. IMF usable resources are presently near \$5 billion, an extremely low level given the present needs of its members and the scale of the world economy. (World exports in 1977 will exceed \$1 trillion.) These usable resources will be increased by about \$6 or \$7 billion when the 6th quota increase becomes effective. The Congress has already authorized U.S. participation in this increase. In addition to the funds I have already mentioned the fund also has access to approximately \$3 billion which remains uncommitted through the General Arrangements to borrow.

Since 1973, the IMF has supplied about \$15 billion of balance of payments financing to member countries. Most of the financing was obtained from the IMF's Oil Facility and Compensatory Financing Facility. The Oil Facility provided funds, when required, on the basis of a country's need for financing of the first-round impact of oil price increases; the Compensatory Financing Facility has provided funds on the basis of a country's need for financing due to a cyclical downturn in its export earnings caused by a drop in world demand such as we experienced in the recent past. Properly, these facilities placed relatively less emphasis on the prolonged adjustment process. The Supplementary Financing Facility is a sensible next stage in financing the adjustment process. It will place greater emphasis on appropriate adjustment policies, rather than simply financing existing deficits. The new facility, with its phased drawings and longer pay-back period, offers flexibility during the difficult adjustment process. Financing from the supplementary facility is likely to be particularly critical for countries whose normal drawing rights in the IMF are too small to finance their adjustment process. Portugal stands as an excellent example of this type of country. In this particular case, as you will recall, a group of some 14 countries have agreed to extend in excess of \$750 million in credits bilaterally.

Portugal is also an excellent example in making the point that the adjustment process in each country must be designed to meet the individual set of problems faced within that country and that in many cases the situation is even more complex than adjusting to higher oil prices. Yet this ad hoc approach to raising official capital which has been so significant in helping to stabilize the economic and political situation in Portugal cannot be repeated country after country. A systematic multilateral approach with appropriate burden sharing and flexibility in determining the pace of adjustment, is needed. This is the genesis of the Supplementary Financing Facility.

THE PERIOD AHEAD

It has long been apparent that the accomplishment of our foreign policy objectives depends in large measure on the existence of a strong and healthy world economy. This economy is built on a viable international monetary system. The most important relations we have with most countries are in the economic sphere—trade, investment, tourism, finance. These relations in turn have an extremely important impact on the U.S. domestic economy, the strength of which is itself an essential ingredient of our ability to carry out an effective foreign policy.

Although the world economy has been buffeted by major shocks, the international financial system has proved to be remarkably resilient. It has been but-

tressed in this time of stress by the strong commitment of the U.S. and other countries to resist protectionism and other predatory practices, to cooperate on economic initiatives, and to commit economic resources to strengthen and preserve the present open system for the benefit of all. It is significant, for example, that all of the industrial countries who are financially able to do so will participate with the United States in the proposed Supplementary Financing Facility. The roughly 50 percent participation by the wealthy OPEC nations is also noteworthy. By channeling a portion of their financial surplus through the International Monetary Fund they also demonstrate their commitment to a viable international financial system.

In conclusion, Mr. Chairman, I believe that our approach to the problem of payments imbalances must contain five broad elements.

First, we need to assure steady expansion of the world economy, an objective which serves our domestic aims and improves global stability. Countries with strong financial positions have a special responsibility in this regard. Countries such as the United States must not run current account surpluses that add to the world adjustment problems. In the aggregate, current account deficits in stronger economies are critically important to the smoother functioning of the monetary system in so far as they represent imports other than oil. These deficits serve the purpose of stimulating economic growth in other economies who cannot finance their adjustment as we can. These countries in turn provide markets for our agricultural and manufactured goods.

Second, the industrial world must also move forward on a long term energy program geared to conservation, accelerated development of alternative energy sources, and research and development. The President's energy proposal for a wide ranging program to reduce United States dependency on imported oil, as well as the multilateral efforts of the International Energy Agency, are of major importance.

Third, to insure that the international economic system functions effectively, deficit countries must continue to have the opportunity and incentive to devise policies that will adjust their economies at a pace consistent with the realities of their social, political and economic situation. The Supplementary Financing Facility provides such flexibility.

The new IMF facility will make an important and positive contribution not only in augmenting the capacity of the IMF to lend to its member states but also to assure the world that a source of official financing exists on a scale that is sufficient to cope with the degree of financial turbulence we are likely to encounter. In short, the Supplementary Financing Facility is as important in its psychological role of backstopping the system as in its role as a source of funds to be used.

Fourth, renewed attention must be focused on the task of facilitating economic growth in both the poorest and middle income developing countries. While few of these countries have a debt problem as such, their development needs remain critical. A resurgence of the world economy will be helpful to these countries but they lack access to both capital and technology. It is here that bilateral and multilateral economic aid play a critical role. These programs play an important part in our program for a stronger and more viable world economy. They should be seen as such and reserve the support of the United States.

Fifth, on Maintenance of a liberal trading system, so others can earn from their exports.

Given these five elements, we believe the deficits which correspond to the OPEC surplus will gradually become geared to the underlying strength of individual country economies and their capacity to sustain external borrowings. In so strengthening the base of our international monetary system, we will also be contributing enormously to the provision of an international environment conducive to effective foreign policy.

STATEMENT OF IRVING S. FRIEDMAN, SENIOR VICE PRESIDENT AND SENIOR
ADVISOR FOR INTERNATIONAL OPERATIONS, CITIBANK, N.A.

Mr. Chairman: I am pleased to accept your invitation to testify before this Subcommittee of the Committee on Banking, Finance and Urban Affairs on the subject of the Administration's request for authorization for the United States to participate in the new Supplementary Financing Facility of the International Monetary Fund (IMF).

My testimony today will undoubtedly reflect my concern for more than thirty years with the types of international financial issues before this Subcommittee while serving in official and private positions, in the U.S. Treasury, the IMF, the World Bank and, now, private banking. In preparing this testimony, I have had the benefit of three questions conveyed to me in advance by Chairman Neal in his letter of invitation of September 8.

As you know, I have authored a recently published book entitled "The Emerging Role of Private Banks in the Developing World" (April 1977). Although it was completed before some aspects of the IMF's new Supplementary Financing Facility had been agreed in final form, the book addresses several of the more important external debt issues in which the Subcommittee on International Trade, Investment and Monetary Policy is interested. For this reason, copies of the book have been forwarded in advance of this hearing to each of the nineteen members of the Subcommittee as my formal prepared statement.

A limited number of additional copies of the book are available here today for Subcommittee staff and other interested persons who may be present. Other additional copies are available by writing to the Office of the Senior Adviser for International Operations, Citibank, N.A., 399 Park Avenue, New York, N.Y. 10022, or directly to me at my home at 6620 Fernwood Court, Bethesda, Maryland 20034.

I would like to provide for the use of the Subcommittee some updated statistics on the external debt situation. These materials are intended to update several key tables from my book which was published in April, 1977 with the best information available through the third week of September.

There are available many estimates of the external debt of developing countries which vary greatly. These differences reflect the coverage in borrowing countries, kinds of loans and credits and sources of loans, the existence of government guarantees and so forth. I would be glad to try to explain these differences, if this is of use to the Committee.

I estimate, for myself, in dealing with the external debt problems of developing countries a total figure of about \$150 billion in disbursed debt at the end of 1976 of which approximately \$40 billion was debt to U.S. private banks. These amounts include lending to lower income oil-exporting developing countries. If we exclude lower income oil exporting developing countries and Mediterranean countries like Yugoslavia and Spain, etc., the corresponding figure would be a total external debt figure of about \$108 billion for the 69 non-oil developing countries which have a significant amount of external debt. I estimate that approximately \$27 billion of this amount was debt to private banks and about \$16 billion was debt to U.S. private banks.²

I intend to be brief in my oral statement today. I would, however, be glad to answer any questions that are not covered in this brief oral statement in the question period which follows.

At the outset, I would like to strongly support Congressional authorization for U.S. participation in the new IMF Supplementary Financing Facility. Mr. Johannes Witteveen, the Fund's Managing Director, has estimated that the new facility will begin operating with resources amounting to at least SDR 8.6 billion (about \$10 billion) available from seven industrial countries and seven oil-exporting countries. The share of the United States is reported to be SDR 1,450 million (about \$1.7 billion) or 17 percent.

The need for favorable and prompt Congressional action is indicated by the fact that the Supplementary Financing Facility as agreed will not become operational until 90 percent of the financing committed by the participating countries has actually been made available. In other words, the new Facility—which I believe is urgently needed—cannot become operational until the U.S., Saudi Arabia, Germany, Japan or any other group of countries comprising more than 10 percent of the \$10 billion committed has in fact supplied its portion of the financing.

I believe that this increase in the Fund's resources will be needed despite the measures currently being taken to add to the Fund's total resources by increases in its quotas by a total of SDR 10 billion (approximately \$11.7 billion). As its name indicates, the facility would supplement the regular credit tranches avail-

²The World Bank's recent re-classification of Trinidad and Tobago as oil exporters has reduced the 71 country sample of non-oil developing countries used in my book to 69 countries.

able to the Fund's members and will not be confined to special purposes as was the IMF's recent Oil Facility. In view of this, it is especially encouraging to note that Saudi Arabia will be the largest contributor to the new facility—about 50 per cent more than the U.S.

Above all, I believe the Supplementary Financing Facility is needed because the influence of the Fund as an international monetary authority is intimately related to the size of its financial resources. The Fund has about 131 member countries, each with its own quota of access to the Fund resources. I believe that the IMF has been and will continue to be handicapped in trying to have its member countries live up to the Fund's code of international monetary behavior, unless each country's quota is large enough to be of significance to that country.

Floating exchange rate systems do diminish the need for international monetary reserves and use of IMF credit, but the needs are still potentially very large. Experience has indicated, during recent years especially, that many countries—including major industrial countries—can be in balance of payments difficulties simultaneously. Under such circumstances, the nations of the world need the assurance of a strong international monetary system. Otherwise, their national programs to reduce unemployment, fight inflation and defend sound development programs in a manner conducive to the well-being of the world economy will be greatly handicapped.

Countries will fear that their efforts will be doomed to failure because other countries in difficulties will not be able to live by the rules of the international monetary and trading systems. In anticipation of this eventuality, countries may well decide in favor of narrow, seemingly self-serving policy approaches irrespective of their international effect, or even irrespective of their longer run harmful effects for the countries acting in this way. This may even prove true for the United States, the largest and strongest country in the world. To avoid this contingency in practice means an IMF able to influence the countries in difficulties to adjust to changed conditions in a manner which serves the best interests of the international community. To influence, it is necessary to be able to help adequately and quickly, if needed.

A very much large Fund is needed in order to have national quotas large enough to give this influence. For these basic reasons, I strongly support both U.S. participation in the special Supplementary Financing Facility as well as the measures being taken to add to the Fund's regular resources by increases in its quotas which Congress approved last fall. These two forms of strengthening the IMF are complementary and meet complementary needs. I will not go into further detail here, since I have previously testified in detail on these subjects before other Congressional Committees in the past year, including testimony for the Subcommittee on International Finance of the Senate Committee on Banking, Housing and Urban Affairs (August, 1977), the Joint Economic Committee (February, 1977) and the Senate Foreign Relations Committee (August, 1976).

As for the "international debt" problem, I would emphasize that developing countries are those whose relatively low income, output and rates of economic growth have for many years required net inflows of resources from abroad to supplement domestic savings and to add to the foreign exchange available from export and other hard currency earnings. In the past four years, a significant number of developing countries which have had the creditworthiness to do so—and I underline this qualification—have substantially increased their external debt to attempt to maintain positive growth rates in the face of the fivefold increase in the price of oil, the worldwide recession, relatively rapid rates of inflation, food shortages, etc.

I would also like to emphasize for this Committee that lending to the developing countries has not constituted a threat to the U.S. banking system. Neither has the substantial borrowing by developing countries from the private banking system been a deterrent to the economic growth of the developing countries. The borrowing of the developing countries from the private system has rather helped the developing countries to adjust to changes in the world economic situation and has strengthened their capacity to service their external debt. I believe the borrowing of the developing countries has done this in two basic ways: (1) by strengthening the ability of the borrowing countries to export and (2) by strengthening the domestic economies of the borrowing countries.

As for the future, I do believe that lending by the private banks to developing countries will increase in the years immediately ahead, but I do not believe it

is possible for me to estimate the amount of increased lending. In trying to project future levels of external debt, one must constantly be aware of the fact that external debt is not only a function of what is likely to happen in the borrowing countries but also a function of what is likely to happen in the world economy. One example of this is the apparently large increases in the magnitude of international lending as rates of inflation increase around the world. In the case of the developing countries, however, levels of external debt have increased at a much more modest rate of growth in the past four years when adjusted for price changes than might be supposed from the nominal increases.

As for the relationship of the proposed Supplementary Financing Facility to the role of the IMF in balance of payments financing, and, in particular, the importance of IMF "conditionality," I am a strong supporter of conditionality in connection with the use of Fund resources. I am pleased to say that I had a key role in introducing and implementing the concept of conditionality in the Fund. Thus, I am especially pleased to note that use of the Supplementary Financing Facility will be made conditional *inter alia* upon agreement between the Fund and the borrowing country of an economic stabilization program which the Fund considers adequate and compatible with its policies for use of the higher credit tranches. I also believe, however, that the IMF should be able at times to come quickly to the aid of a country which has urgent and immediate balance of payments problems, particularly in cases where the failure to do so would result in long term damage to the economy of the borrowing country.

In recent Senate testimony on the subject of the Supplementary Financing Facility, I urged serious consideration by the U.S. Government and the general public of an increase in the regular resource of the IMF to a much larger total of approximately \$100 billion. In fact, I had already urged a Fund of this general magnitude as early as 1970-71 because of the strains already being experienced in the international monetary system at that time. A \$100 billion Fund would have about twice the resources of the current Fund, assuming the new quota increases and the Supplementary Financing Facility go into effect.

In recent months, a number of differing proposals have been advanced setting forth a variety of ways and means of expanding the size of the Fund. Some of these proposals have been based on the substantial increases in international lending and the inflation-induced decline in the real value of Fund resources since 1970. Other proposals have cited the relatively rapid growth of world trade beginning particularly in the decade of the 1960s. Still other proposals have been based on the substantial expansion of the reserve positions of countries since the early 1950s. All of these arguments have merit.

My most basic point, however, is that the total financial resources of the Fund today must be large enough to enable the Fund to play its appropriate role in sustaining and renewing confidence in the international monetary system. For more than thirty years, the Fund has played this role in protecting the prosperity of countries both by supplying liquidity on a conditional basis at critical points in the monetary system and by preventing a return to inconvertibility of currencies and widespread use of exchange restrictions.

The contributions of the Fund in this process have helped make possible both the rapid expansion of the world economy and world trade in the 1960s, but this has also made the international economic framework more vulnerable to unexpected shocks. The Fund may well not be able to cope with these kinds of unexpected shocks, however—if they occur in the future—if it can only rely on special or emergency devices which need to be internationally agreed every few years.

From a creditor point of view, the size of the resources entrusted to the Fund will reflect the confidence of nations in the Fund. More importantly, it will demonstrate their determination to avoid a repetition of the worldwide retrenchment which we call the Great Depression of the 1930s. It will also reflect the determination to enable well managed developing countries to continue sound development efforts—without the albatross of balance of payments difficulties not resulting from their own economic mismanagement.

Another question which has been frequently raised is the question of whether the Supplementary Financing Facility or any increase in Fund resources will not in effect serve to "bail out" private banks. My basic answer to this criticism of the Supplementary Financing Facility is that I do not believe that Fund resources should be used for this purpose. It is in fact quite possible to insure by means of Fund conditionality that this will not be so. In other words, the Fund can insure that no country will get IMF money to repay private banks.

It should be clear, however, having said this, that all new lending augments the total foreign exchange availability of a country. In this general sense, borrowing from the Fund helps countries repay private banks—due to the fungibility of money—as well as meet all other external payments needs. Similarly, borrowing from private banks helps countries to repay the Fund by augmenting the foreign exchange available to a country.

Thus, to conclude, may I reiterate my support for the proposed new IMF facility.

Thank you.

APPENDIX B

DEPARTMENT OF STATE,
Washington, D.C., November 16, 1977.

Senator FRANK CHURCH,
Chairman, Subcommittee on Foreign Economic Policy, Senate Foreign Relations
Committee, Dirksen Senate Office Building, Washington, D.C.

DEAR SENATOR CHURCH: On October 6, 1977, Deputy Assistant Secretary Erland Heginbotham appeared before your subcommittee to discuss the historical developments relating to financial difficulties experienced by Pertamina in the year 1972-1975. During the hearing, the subcommittee made three requests for information. This letter transmits the information we have been able to develop.

First, enclosed with this letter is a copy of the outline followed by Mr. Heginbotham during his appearance. The Department has no objection to including this statement in the hearing record.

Second, Senator Sarbanes requested submission of a fact sheet on the amount and composition of the debt for inclusion in the hearing record. The information that we have developed follows. Since we cannot attest to its accuracy, we would appreciate if the statements at the bottom of the table were included with the table.

Estimated Pertamina Liabilities as of December 31, 1974¹

1. Current liabilities—notes payable-----	\$1,000,000,000
2. Long term debt due in 1 year-----	175,000,000
3. Long term debt due after 1 year-----	855,000,000
4. Principal payment for tankers covered under time charter agreements -----	² 3,300,000,000
	<hr/> 5,330,000,000

¹The above information is considered as only a best estimate and its accuracy cannot be assumed. In addition, there is no general agreement as to the definition of liability in the case under discussion. For example, at 1 one Pertamina failed to transmit approximately \$850 million in royalty payments to the Government. However, it has been reported that these funds were being used to assist in constructing a government-owned steel project for which Pertamina was given responsibility. If this \$850 million were included as a liability the total would reach \$6.2 billion rather than \$5.3 billion.

²This debt has subsequently been renegotiated and the eventual cost to Pertamina is much reduced.

Toward the end of the hearing, Senator Sarbanes requested information concerning syndicate leaders and Mr. Heginbotham offered to provide information on this topic to the subcommittee. The information is classified and the Department has provided it to the appropriate subcommittee staff under separate cover.

If I can be of any further assistance please do not hesitate to call.

Sincerely yours,

DOUGLAS J. BENNET, Jr.,
Assistant Secretary for Congressional Relations.

APPENDIX C

OUTLINE OF OBSERVATIONS: CASE STUDY OF PERTAMINA FINANCIAL SITUATION

I. COUNTRY SETTING—INDONESIA 1971-76

A. Aftermath of Sukarno era

1. Political—Strategic significance of Indonesia's change of course in 1965-66 from a virtual communist state to a pro-Western, non-aligned country.

2. Economic Conditions in 1965-66: (a) 600 percent annual inflation; (b) infrastructure in ruins; (c) per capita well below \$100, negative GNP growth rate; (d) disinvestment by foreign firms; (e) negative foreign exchange reserves.

B. Suharto economic policies

1. Economic technocrats introduced fiscal responsibility, balanced budget, and predominant dependence on concessional financing.
2. Rescheduling of \$2 billion Sukarno period external debts.
3. Conclusion of standby agreement with IMF.
4. Renewed development effort with support of IGGI (Intergovernmental Group for Indonesia).
5. Inflation rate reduced to less than 10 percent by 1970.
6. New foreign investment and oil laws introduced—investment inflows approaching \$2 billion per year by 1972 (oil and non-oil).

C. Internal politics of economic development

1. Military leadership appoints foreign-trained technocrats (with no personal power base) to run economy.
2. General Ibnu Sutowo, already a leader in the Government's oil structure, was entrusted by General Suharto with reorganization and pulling together of the splintered oil industry into Pertamina.
 - a. Ibnu achieved dramatic international breakthrough on terms for oil exploration; fathering production sharing concept; quickly got foreign oil to invest heavily in Indonesia following severe difficulties in Sukarno era.
 - b. Ibnu expands oil production from 600 thousand barrels per day in 1968 to 1.2 million barrels per day by 1972. Acquires broadening responsibility for oil sector-related activities.
 - c. His pragmatism, reliability and judgment achieved for him the respect and confidence of President Suharto, international oil and banking communities, and gained Indonesia an extraordinary level of foreign oil investment. President Suharto had confidence in his ability to get things done; assigned him special projects and relied on Ibnu to find financing for them.
 - d. Ibnu gained international status; had ready access to European heads of government.
3. Anomaly of Indonesia's two development tracks:
 - a. Broad track centered around "technocrats using conservative fiscal policies, supported by IMF and IBRD; pace of development constrained by careful studies linked to prior assurances of concessional financing.
 - b. Oil sector track (initially including investments in housing, education and infrastructural facilities to permit relocation of oil sector support from Singapore to Indonesia) was gradually broadened to include petrochemicals, fertilizer and gas-based steel industry:
 - (1) Reliance on rapid decisions, commercial financing, and profit advantages linked to accelerated implementation.
 - (2) Emphasis on self-liquidating projects.
4. Problems created by dual track:
 - a. Both tracks reported directly to Suharto
 - b. Coordination between tracks was minimal
 - c. Pertamina data and management deficiencies further impede coordination possibilities.
4. Competition developed with each track striving to demonstrate its approach development was more effective.

D. International politics of oil

1. Significance of Indonesia's OPEC membership: (a) Indonesia's reserves and production represent 2 percent of world total.
2. Indonesia joined OPEC to be close to decisions on its main export.
3. Early participation as silent member only.
4. Did not participate in 1973-1974 Arab oil embargo.
5. Became an increasingly important supply source for US during embargo, reaching 12 percent of U.S. oil imports at that time.
6. Its significance for supplying the US increased with discovery of natural gas; large volume was reserved for export at LNG to southern California utilities.
7. Even OPEC's fourfold price increase contributed only \$25-\$30 per capital to Indonesia's annual income.

8. Even by 1977, Indonesia remains one of the poorest LDCs, at about \$200 GNP per capita.

9. Indonesia's oil export does not begin to meet its development financing needs—it requires some \$2 billion annually of concessional aid to sustain current growth of 5-6 percent, at present low per capita income levels.

E. U.S. economic policy interest

1. *Stabilization and development policy.*—The U.S. strongly supported Indonesia's return to a responsible conservative financial policy and its restoration to high priority of a sound economic development position; Indonesian policies have contributed to stability in all of Southeast Asia.

2. *Commercial opportunities.*—U.S. policy also aimed at mutually beneficial trade and investment relations. We foresaw important mutual opportunities for U.S. commercial participation particularly in major oil, industry and infrastructure projects.

3. *Energy supplies.*—With the Arab embargo, Indonesia's oil and gas acquired increased importance for the U.S.

II. PHASES OF INDONESIA'S EXTERNAL DEBT DEVELOPMENT, 1971-76

A. Phase I: Ibnu's search for financial alternatives (1971 May 1973)

1. Pertamina capital project priorities exceeded fund availability.
2. Pertamina borrowing had exceeded GOI limits on 3-15 year credits in fiscal year 1972 (by December 1972).
3. USG suspended program loan eligibility in support of IMF efforts to obtain remedy of Pertamina borrowing excess (December 1972).
4. Discussions with private banks achieved modification in bank lending practices (Jan., 1972).
5. USG, IMF and GOI¹ consider standby borrowing limit flexibilities to permit financing of self-liquidating Pertamina projects. (Feb.-March 1973)
6. IMF/GOI standby agreed to in May 1973, with specific ceilings on new Pertamina borrowing (1-15 years); evidence of over-borrowing by Pertamina in fiscal year 1972 reported to IGGI.
7. Technocrats issue control regulations, but provide no penalty, nor provisions to invalidate credits above agreed ceilings. (May 73)
8. Commercial banks begin to participate with U.S. Exim Bank in financing of new oil refinery (May-July 1973).

B. Phase II: Shift By Pertamina in borrowing practices (May 1973-May 1975)

1. Evidence emerges of large 360-day borrowings by Pertamina to finance additional capital projects. (October 1973)
2. IMF, U.S. Embassy and GOI seek in formation on extent of Pertamina borrowings; Pertamina does not cooperate with GOI efforts to monitor its borrowings. (October-November 1973)
3. Banks and Pertamina take initial steps toward upgrading its financial management, accounting and financial statements; plans for international floatation by Pertamina are initiated with assistance of U.S. investment bank. Pertamina employs major U.S. computer and accounting firms to assist in improvement of financial controls. (July 1973-February 1974)
4. Suharto assigns Pertamina responsibility for Krakatau steel project and certain fertilizer plant developments; competition between (a) Ibnu style of commercial financing and project implementation, as opposed to (b) conservative technocrat approach reaches apogee as frustrations mount with progress of aid implementation; GOI participates in Krakatau steel financing, with loan guarantees, as means of supervision of Pertamina financing. (July 1973-Feb. 1974)
5. Gradual discoveries of additional Pertamina borrowing reveal substantial overrun of GOI borrowing ceilings. (October-December 1973)

C. Phase III: The unraveling (May 1974-February 1975)

1. Tightening international money markets reportedly complicate Pertamina medium-term credit access (May 1974).
2. Pertamina faces increasing difficulty in persuading creditors to roll over 360 day credit (September 1974). Many terminate by November.

¹ Government of Indonesia.

3. Major quarterly payments on Krakatau project (\$170 million) begin falling due (September 1974).
4. Oil exports begin to fall substantially short of expectations; production levels fall from 1.3 million b/d to around 1.1 million (end of 1974).
5. Pertamina fails to submit oil company tax payments to GOI in October (\$250 million) and again in January, 1975.
6. Pertamina fails in effort to obtain large Arab loan (December 1974, January 1975).
7. Pertamina unable to meet payment due U.S. bank in mid-February; group of 24 foreign bankers is present in Jakarta for revelation of Pertamina's liquidity crisis.

D. Phase IV: The resolution (March 1975-June 1977)

1. Based on decisions by President Suharto, Bank Indonesia advises that government financing will ensure that Pertamina meets all legitimate current financial obligations (March 3, 1975): GOI assumes charge of all Pertamina financing needs, ordering it to suspend further world money market activities; President Suharto appoints Finance, Defense and Presidential secretariat officials to evaluate Pertamina's condition, budget and development projects. (March 1975)
2. GOI begins to provide funds for meeting overdue and current loan payments (March 1975).
3. Central Bank Governor and Minister of State for Economy visit European financial capitals to reassure money markets of Indonesia's continued financial integrity. (March 1975)
4. GOI contracts with three major international investment banks to advise it in restructuring and management of Pertamina and GOI external indebtedness. (March 1975)
5. GOI arranges four major loan syndications through key U.S., European and Japanese investment houses, for \$1.2 billion in longer term financing to pay off short term Pertamina borrowings. (April, June and November 1975)
6. GOI appoints Minister for Administrative Reform to review and restructure Pertamina projects; he cancels some, cuts others back. (March-April 1975).
7. GOI undertakes renegotiation of large foreign commitments by Pertamina, including tanker charters and Krakatau steel project agreements. (April-May 1975)
8. GOI replaces senior officials of Pertamina; appoints GOI budget director as new head of Pertamina. (May 1975)
9. Several overdue acceptances create uncertainties about GOI credit position; GOI accelerates settlements by end of month. (May 1975)
10. GOI obtains Saudi funding for two major projects (June 1975).
11. GOI concludes agreement settling majority of outstanding tanker charter claims thus resolving the last significant cloud over current financial horizon. (June 1977)
12. IBRD projects GOI debt service burden will peak at 19 percent of exports in 1980 and decline thereafter (20 percent considered highest "safe" level).

APPENDIX D

[From the American Banker, Sept. 15, 1977]

POLITICAL IMPLICATIONS OF RECYCLING FUNDS OVERHANG WORLD BANK, IMF MEETINGS

(By M. S. Mendelsohn)

LONDON.—The recycling of funds from the world's surplus countries to deficit ones is a subject that is going to crop up yet again at this year's annual meetings of the World Bank and International Monetary Fund, beginning in Washington Sept. 26.

Delegates in the conference hall will be talking about recycling, while commercial bankers in corridors and at cocktail parties will be busy arranging still more recycling by canvassing deposits from the rich and loan applications from the poor.

What the meeting will not be discussing, so far as the agenda shows, but what delegates and commercial bankers probably should be discussing are the political

implications of the massive claims which the western banking system continues to build up on developing and East European countries. The sums which these two classes of borrowers owe to western banks have risen well above \$100 billion and have grown so rapidly in the four years since the oil crisis that the problem posed by this kind of lending has changed in kind, not merely degree.

Yet nearly every discussion of payments recycling through the western banking systems has so far concentrated narrowly on the financial implications alone, while ignoring the fact that western bankers are being sucked ever deeper into a foreign policy vacuum through the sheer scale of their lending to sovereign borrowers.

The debate about the financial implications has become so familiar that it can be recapitulated briefly. The most common view is that while some more borrowing countries may run into difficulties forcing them to reschedule their repayments, the system as a whole cannot break down because the sum of the world's current payments deficits must always exactly match the sum of surpluses. In the phraseology coined by Robert Solomon, a former adviser to the Federal Reserve Board and now at the Brookings Institution, "necessitous borrowers" will always find their "necessitous lenders."

The argument about the financial implications then continues that the trend of world payments will also be offsetting in its own way. That is, an economic slack in the western industrial countries provides liquidity for bank lending to developing countries and eastern Europe, while an economic upturn in the West allows those countries to reduce their current deficits. And this has indeed been happening to a limited extent during the latest four years of the world's economic cycle. During the deep recession of the western economies in 1974-75 the current deficits of oil-importing developing countries and eastern European countries rose to new heights, because their export opportunities were curtailed. During the recovery of the western economies over the past two years, those deficits have been shrinking. Now those deficits are expected to start expanding again as growth of the western economies slows once more.

The renewed slowing of the western economies, which now seems to have started as widely forecast, does threaten to make more acute the financial problem posed by western bank lending to sovereign borrowers faced with shrinking markets and falling prices for their exports. And this makes it likely that more countries will run into difficulties with their repayments as Zaire, Peru and Turkey have. But the political difficulties, so widely ignored, are likely to become more acute as well.

The political implications are that bankers begin to assume a foreign policy role from the moment they start lending to sovereign borrowers on any large scale, and certainly when they undertake such lending on the scale of the past four years. The provision of finance to sovereign borrowers is always a form of aid to exporters supplying the borrowing countries. That immediately involves bankers in passively helping to determine priorities both for supplying and purchasing countries. In other words, their lending helps decide which western export industries are helped, as well as the pattern of consumption, display, armaments expenditure and productive investment in borrowing countries.

Another way of saying this is that all sovereign credits represent the financing of unrequited exports, and the questions are what exports, to which countries, for which purposes and for how long? These are essentially foreign-policy questions which bankers are neither elected nor trained to decide and there is no evidence that bankers are in the least eager to become embroiled in such questions. They have been dragged into this role entirely through a default in western foreign policy.

Moreover, to the extent that bankers do become involved in such matters, their motivations are different from those of governments. Bankers are concerned with the most efficient allocation of resources, meaning the kind of investments that promise to generate enough money to pay for themselves. On the other hand, governments, in this case of the western creditor countries, are concerned not only with allocation of resources but also with such nonfinancial considerations as the extension of support to friendly foreign countries and the withholding of support from hostile or potentially hostile countries.

Besides this, only the governments of creditor countries have the political mandate and the means to decide whether their electorates will accept the cost of financing unrequited exports either in terms of foreign markets forgone or forgoing competitors built up. It is not a matter of whether bankers or governments

will be more "right" about such questions. It is whether bankers or governments should properly have the responsibility for deciding them.

Such problems merely become more acute when lenders are forced to impose conditions on borrowers, as currently in Zaire, where the banks are seeking to "monitor" that country's imports, which is a polite way of saying that they want to dictate what Zaire may import and what it may not. Yet this kind of difficulty is going to become more widespread even in the case of borrowing countries which are not forced actually to reschedule. The reason is that some eastern European and nonoil developing countries have borrowed so heavily from western banks that even a normal cyclical upturn of the western economies no longer provides an assurance that they will be able to reduce their debts to more manageable proportions.

Given the size of their debts, only three courses are possible:

Western markets will have to be opened far more widely to the manufactured and raw materials exports of the borrowing countries, so that they can earn their way out of debt—which will obviously create difficulties with industrial lobbies in western countries.

Or conditions imposed on borrowing countries may threaten the survival of their governments, for good or ill in the way that riots in Egypt, Poland and Peru have threatened although not toppled the governments of those countries in the past 18 months.

Or, third, some part of the growing western banking claims on sovereign borrowers may eventually have to be funded as official bilateral claims, in which case electorates in the creditor countries may ask why they were not consulted in the first place, and that kind of public reaction might take a form which bankers would not welcome.

The attempts so far made to underpin commercial bank lending to sovereign borrowers have not come anywhere near facing the political implications. The IMF, which has just secured a new \$10 billion oil facility, can do no more than impose general monetary and fiscal constraints on debtors for limited periods. But the IMF has neither the authority nor the mandate to impose political conditions and no body with 131 member countries can possibly have a foreign policy of its own. The Bank for International Settlements, proposed as a center for pooling information about debtor countries, is confined to an even more limited if inherently useful role.

If more political responsibility is to be restored to governments, with which it belongs, one way would be through an increase in official bilateral and multilateral aid flows, which actually fell both in money and real terms last year.

Another approach might be through a considerable increase in the guarantees provided by the official export insurance agencies of the main western countries, like the United States Export-Import Bank, Britain's Export Credits Guarantee Department and their counterparts in other countries like Germany and France.

But it would be difficult extending such guarantees to programme financing extended by international bank syndicates, so yet another possibility might be a revival in a modified form of the forlorn "safety net" of the Organization for Economic Cooperation and Development. This might allow bank funds to be raised under the guarantee of OECD governments for lending not only within OECD but also to countries which are not members, on the premise that OECD can more readily be used as a channel of western international economic policy than can the IMF. Robert Roosa of Brown Brothers Harriman has suggested something along these lines.

APPENDIX E
CHART 1

Percentage Breakdown of Mid-East Oil Exporters' Banking and Portfolio Security Placements in the United States, by Type, 1974-1977 (1st Half)

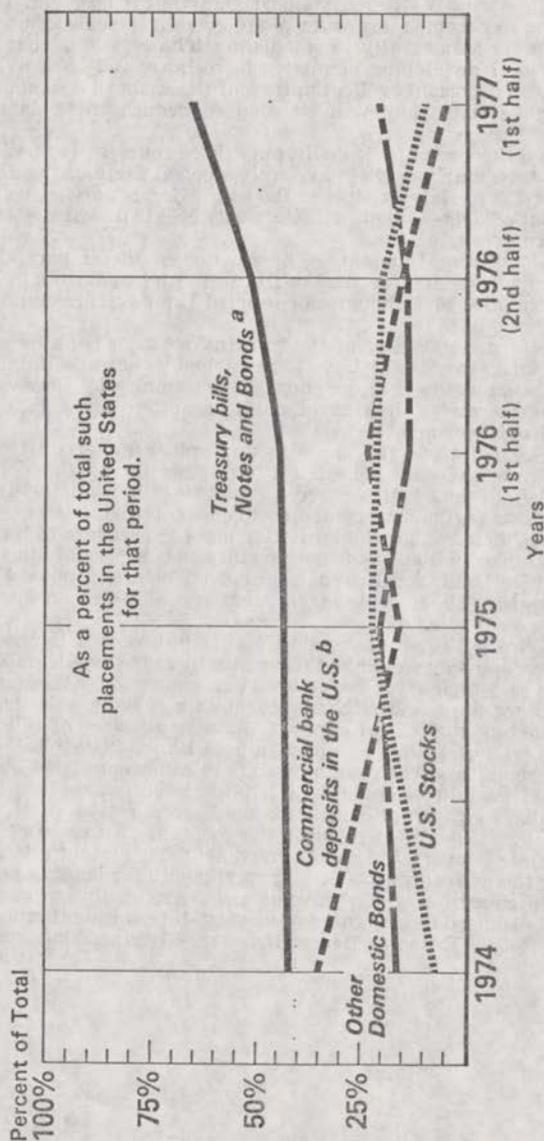


CHART 2

Total United States Banking and Security Placements by Oil-Exporting Countries 1974-1977 (1st half)

Total Banking and Portfolio Security Placements by Middle-East Oil Exporting Countries in the United States and in the Foreign Branches of Major U.S. Banks. 1974-1977 (1st half)
(net placements; in billions \$)

Year	Placements in the United States ^a	Quantity of Deposits in Foreign branches of U.S. banks at a given date. ^b	Total placements in the United States and Foreign branches
1974	\$ 5.5 (2.3)*	\$ n.a.	\$ n.a.
1975	7.6 (3.3)	10.7	18.3
1976	8.8 (4.0)	10.8	19.6
1976 (1st half)	5.5 (2.4)	10.0	15.5
1976 (2nd half)	3.3 (1.7)	10.8	14.1
1977 (1st half)	4.7 (3.0)	10.3	15.0
Grand Total up to June 30, 1977	\$26.6 (12.7)	\$10.3	\$36.9

Total Banking and Portfolio Security Placements by African Oil Exporters, Venezuela, and Indonesia in the United States and the Foreign branches of Major U.S. Banks. 1974-1977 (1st half)
(net placements (+) or withdrawals (-); in billions \$)

Year	Placements in the United States ^a	Quantity of their Deposits in Foreign branches of U.S. banks at a given date. ^c	Total placements/withdrawals (-) in the United States and Foreign Branches of U.S. banks
1974	\$ 5.3 (3.1)	\$ n.a.	\$ n.a.
1975	-1.4 (-.9)	-1.1	-2.5
1976	-1.0 (-.9)	-1.0	-2.0
1976 (1st half)	0.2 (.4)	-1.6	-1.4
1976 (2nd half)	-1.2 (-1.3)	-1.0	-2.2
1977 (1st half)	-0.9 (-.6)	-1.2	-2.1
Grand Total up to June 30, 1977	\$2.0 (+.7)	\$ n.a.	\$ n.a.

^a This excludes real estate, other direct investment, prepayments on U.S. Exports, debt amortization, etc.

^b Numbers given are for Dec. 31, or June 30 of that period.

^c Numbers given are for Dec. 31, or June 30 of that period, except 1977; 3/31/77.

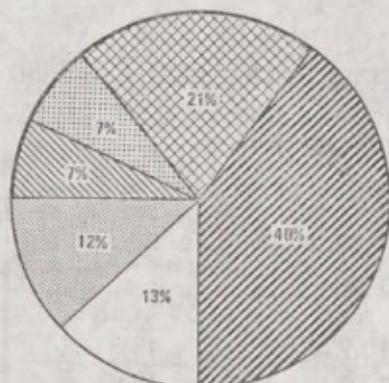
n.a. Not available.

Sources: U.S. Treasury Department; Federal Reserve.

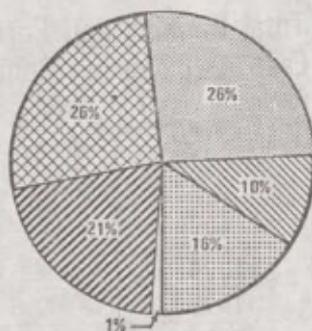
*() Quantity total which is made up of Treasury notes, bills and bonds.

CHART 3

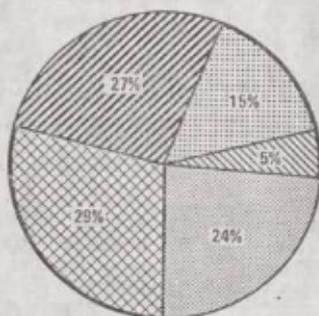
Disposition of OPEC Surpluses Throughout the World 1974-1977 (First Quarter)



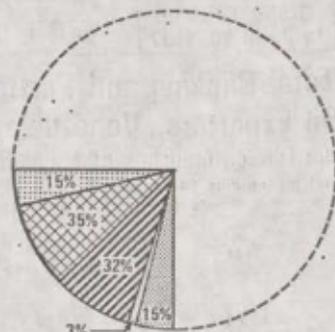
1974
Total Surplus
\$56.3 Billion



1975
Total Surplus
\$38.3 Billion



1976^b
Total Surplus
\$37.5 Billion



1977 (Q1)
Total Surplus
\$10 Billion

The United States^a

International Financial Institutions

Developing Countries

EuroBanking Market

Other Developed and Non-Market Countries

United Kingdom

^a This does not include placement of funds in offshore branches of U.S. Banks, which appear in the EuroBanking market share.

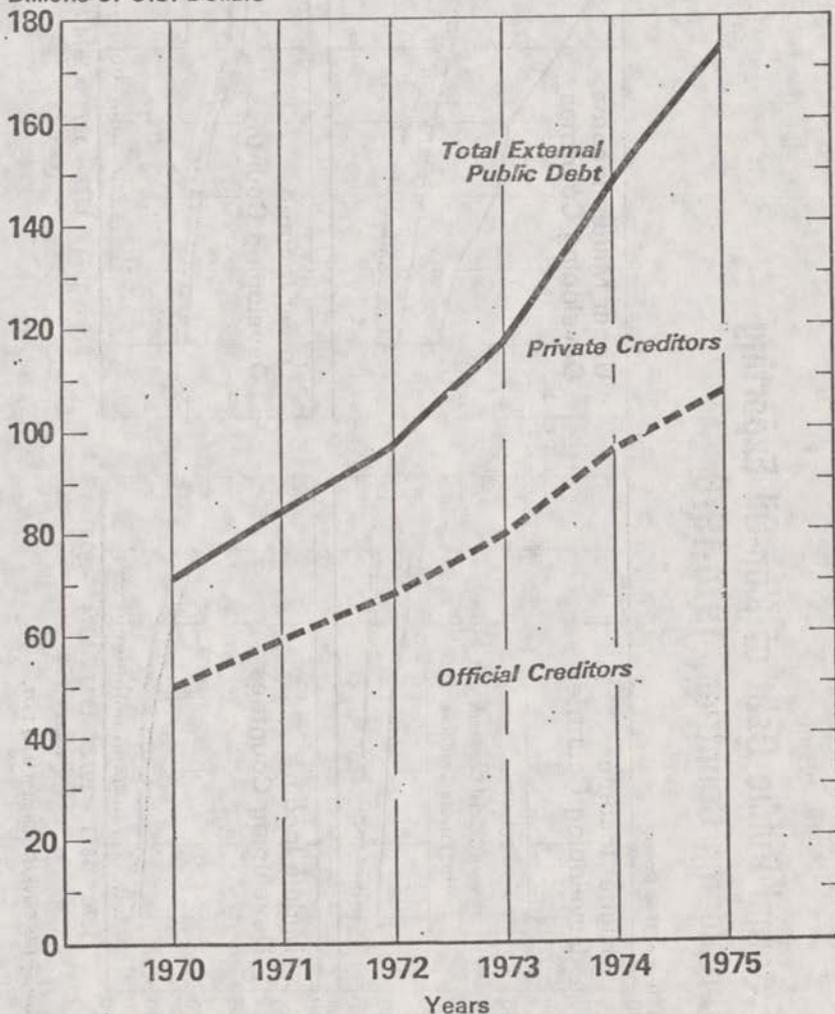
^b 1976: \$1 billion was removed from U.K. and placed elsewhere, hence \$38.5 billion was distributed.

Source: U.S. Treasury Department.

CHART 4

External Public Debt of 84 Developing Countries, 1970-1975

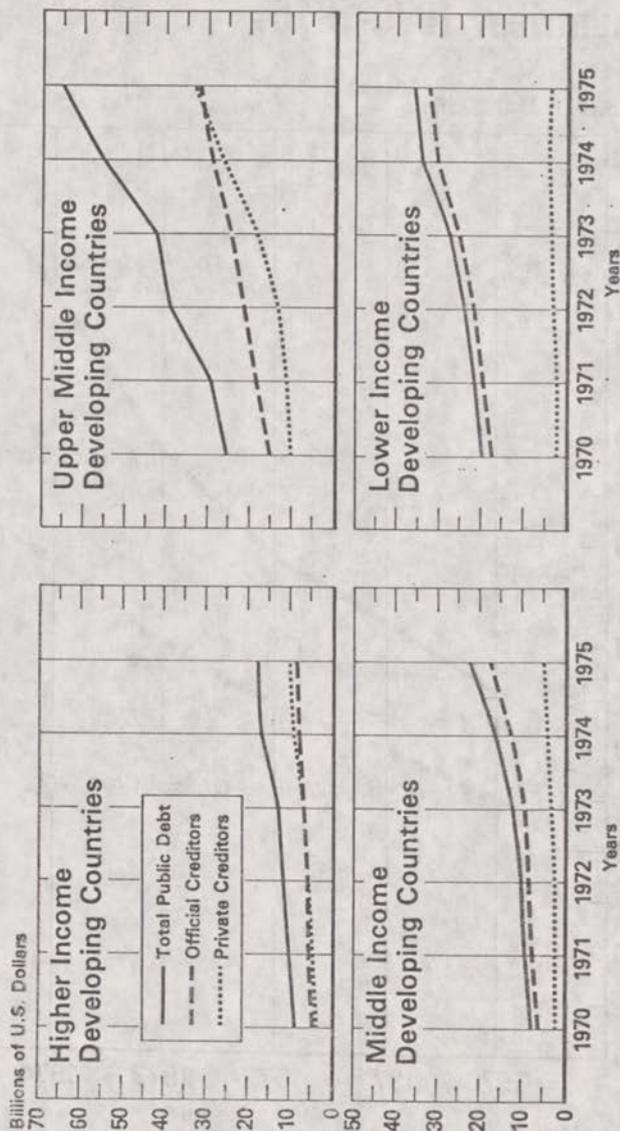
Billions of U.S. Dollars



Source: IMF Survey Supplement, June 1977.

CHART 5

External Public Debt of Non-Oil Exporting Developing Countries, 1970-1975



LIST OF COUNTRIES IN REPORTS NO. 1595, 1674, AND EC-167/77
(Based on 1975 GNP per capita income in 1975 US dollars)

Oil Exporters

- + *Algeria (\$521-\$1075)
- + *Ecuador (\$521-\$1075)
- *Gabon
- ✓ + *Indonesia (\$265 or less)
- + *Iran (over \$1075)

- *Iraq
- + *Nigeria (\$266-\$520)
- *Trinidad and Tobago *a/*
- + *Venezuela (over \$1075)

Higher Income (over \$1,075)

- + *Argentina
- *Cyprus
- Greece
- ✓ + *Jamaica
- Malta
- ✓ Portugal
- *Singapore
- ✓ Spain
- *Uruguay
- + *Yugoslavia

Upper Middle Income (\$521-\$1,075)

- ✓ + *Brazil
- + *Chile
- *China, Rep. of
- + *Colombia
- *Costa Rica
- *Dominican Republic
- *Fiji
- + *Guatemala
- *Guyana
- + *Korea, Rep. of
- + *Malaysia
- *Mauritius
- ✓ + *Mexico
- *Nicaragua
- *Panama
- *Paraguay
- ✓ + *Peru
- + *Syria
- + *Tunisia
- ✓ + *Turkey
- + *Zambia

Middle Income (\$266-\$520)

- + *Bolivia
- *Botswana
- + *Cameroon
- *Congo, People's Rep. of
- + *Egypt
- *El Salvador
- + *Ghana
- *Honduras
- + *Ivory Coast
- *Jordan
- + *Liberia
- *Mauritania
- + *Morocco
- + *Philippines
- + *Senegal
- + *Sudan *b/*
- *Swaziland
- + *Thailand
- *Togo

Lower Income ((\$265 or less)

- *Afghanistan
- + *Bangladesh
- *Benin
- *Burma
- *Burundi
- *Central African Empire
- *Chad
- + *Ethiopia
- *Gambia
- + *India
- + *Kenya *a/*
- *Lesotho
- + *Madagascar
- *Malawi
- *Mali
- *Niger
- + *Pakistan
- *Rwanda
- *Sierra Leone
- *Somalia
- + *Sri Lanka
- + *Tanzania
- *Uganda
- *Upper Volta
- *Vietnam *c/*
- ✓ + *Zaire

a/ Classified as middle income in Report 1595.

b/ Classified as low income in Report 1595.

c/ Report 1595 only.

+ Included in Sample Panel in Report 1674, Annex Table 1.

* Included in Report 1595.

External Public Debt of Oil Exporting Developing Countries, 1970-1975

Billions of U.S. Dollars

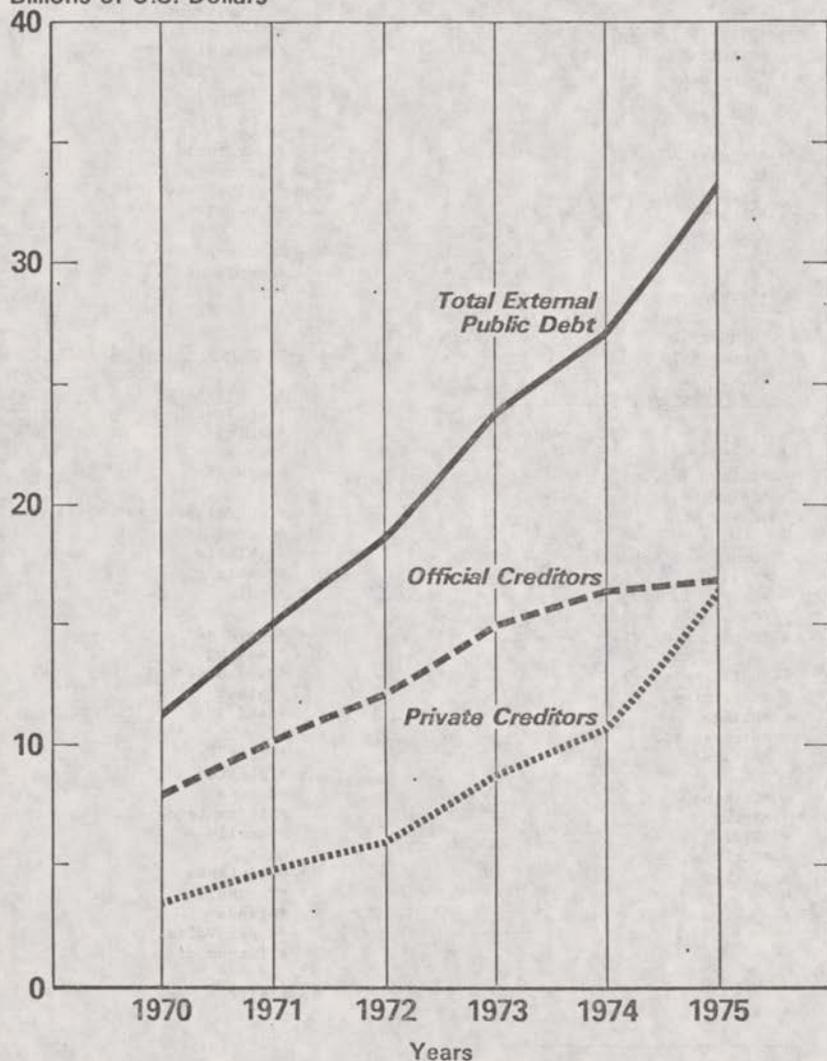
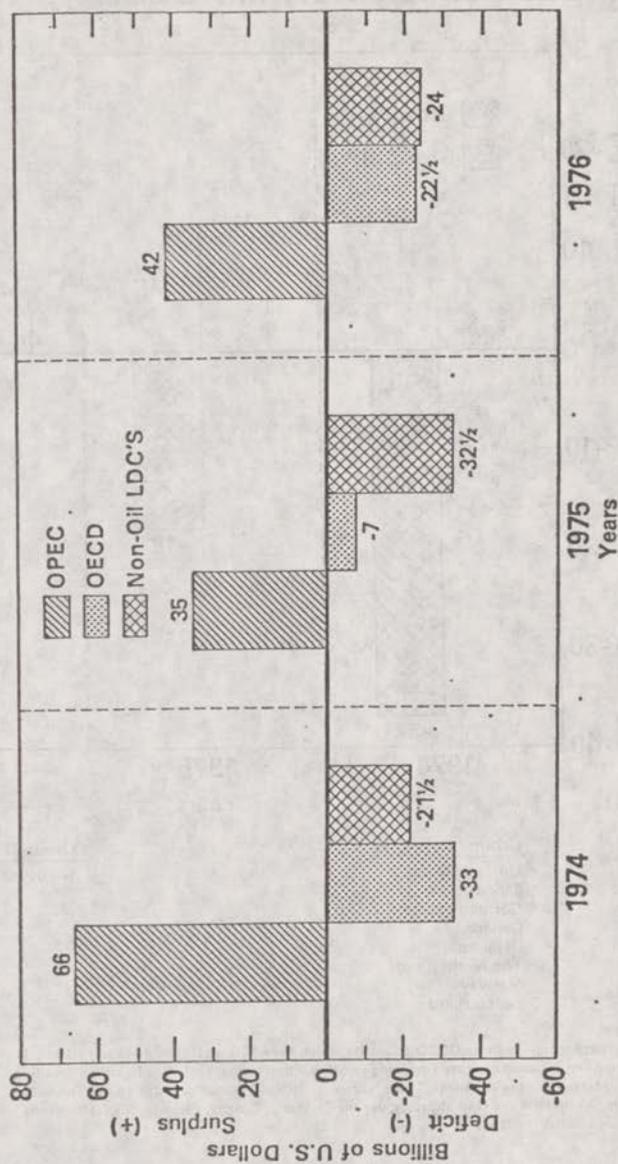


CHART 7

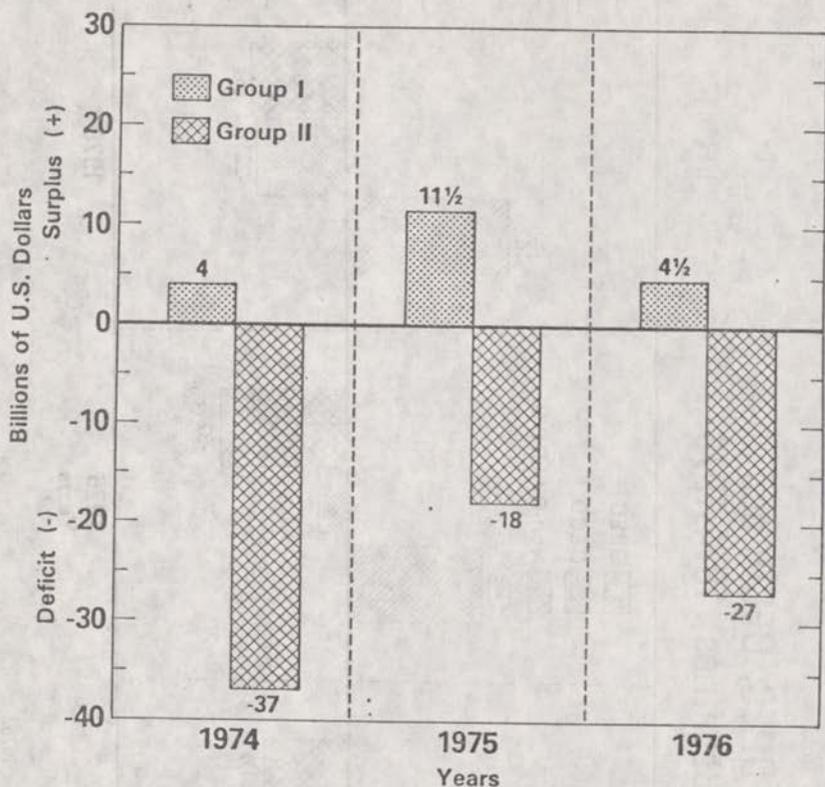
Current Balances of OPEC, OECD, and Non-Oil Developing Countries, 1974-1976



Source: OECD Economic Outlook, December 1976.

CHART 8

Current Balances within OECD^{a/}, 1974-1976



Group I Countries

United States
Japan
Germany
Canada
Belgium
The Netherlands
Norway
Switzerland

Group II Countries

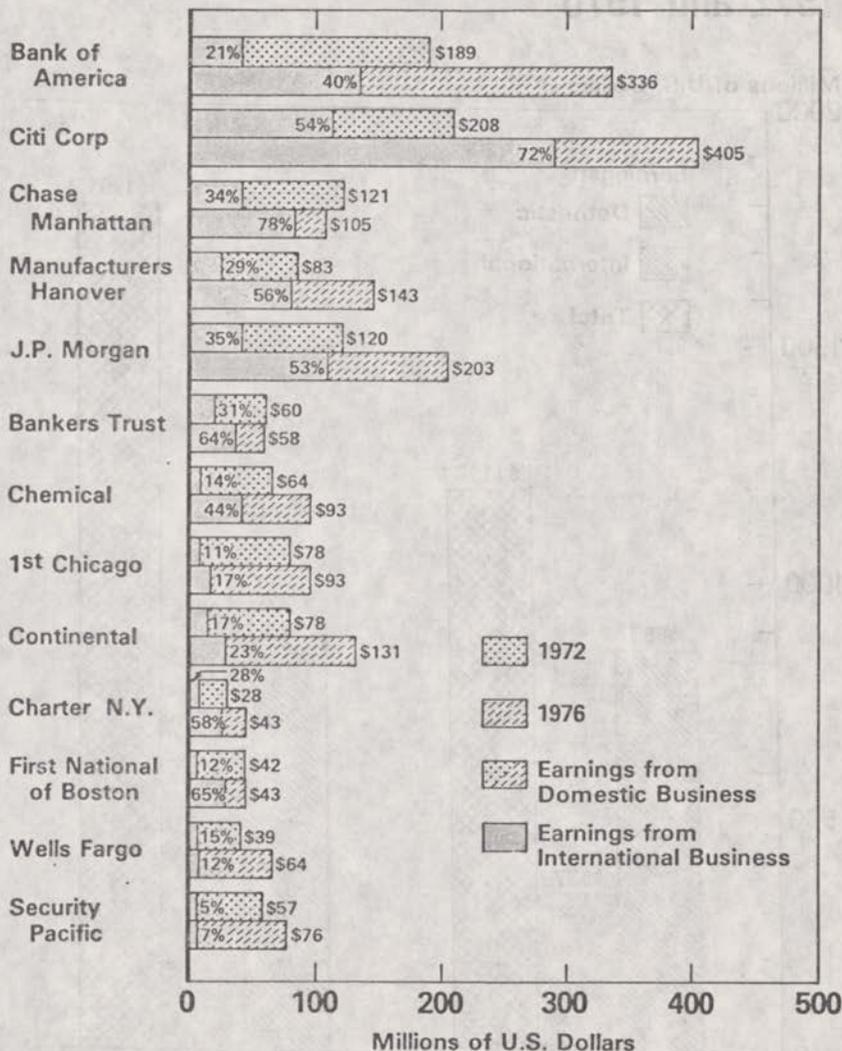
All other OECD Members

^{a/} The groups comprise those OECD countries which have (Group II) and have not (Group I) had recourse to compensatory financing or official borrowing, excluding liabilities resulting from intervention in the "snake," plus Norway which is a special case due to oil. The countries in Group I are the United States, Japan, Germany, Canada, Belgium, the Netherlands, Norway and Switzerland.

Source: *OECD The Economic Outlook for 1977*.

CHART 9

Total, International and Domestic Earnings of 13 Large U.S. Banks for 1972 and 1976

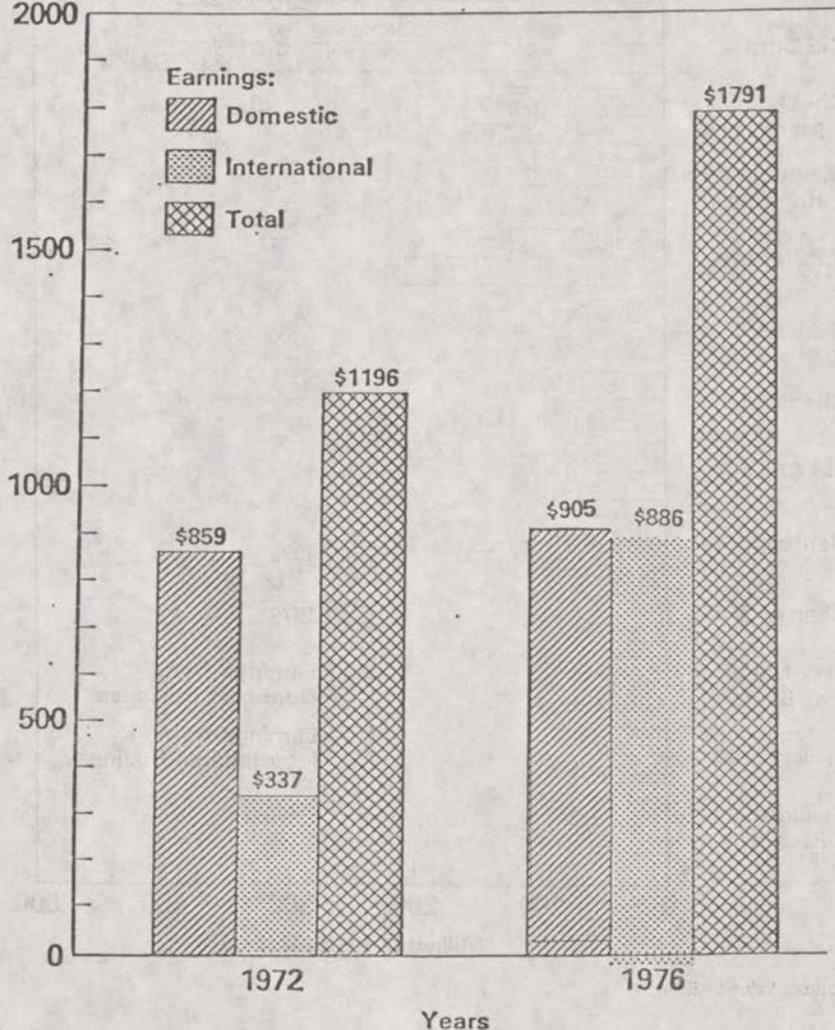


Source: Salomon Bros.

CHART 10

Aggregate Earnings of 13 Large U.S. Banks Domestic and International Earnings for 1972 and 1976

Millions of U.S. Dollars
2000



SUMMARY TABLE OF TREASURY DEBT MANAGEMENT OPERATIONS IN NOTES AND BONDS

[Amounts in millions of dollars]

Year and quarter	Amount maturing domestically held	Net new money raised in domestic market	Additional money raised through direct sales to foreign accounts net of maturities	Total new money
1976:				
April to June	7,598	9,154	815	9,969
July to September	7,665	15,239	1,040	16,279
October to December	8,862	10,154	1,415	11,569
1977:				
January to March	5,636	12,395	2,030	14,425
April to June	9,605	3,668	2,260	6,520
July to September	6,627	9,082	2,476	11,558

1 Does not include 2-yr note maturing Sept. 30, 1979.

TREASURY DEBT MANAGEMENT OPERATIONS IN NOTES AND BONDS

[Amounts in millions of dollars]

Payment date of new issue	Coupon	Maturity date of new issue	Amount maturing domestically held	Net new money raised in domestic market	Additional money raised through direct sales to foreign accounts net of maturities	Total new money	Total new issues publicly held (excluding foreign official)
Apr. 15, 1976	7½%	Feb. 15, 1981		2,500	115	2,615	2,500
May 17, 1976	6½%	Apr. 30, 1978	4,100	2,600	200	2,800	6,700
Do	7½%	May 15, 1986					
Do	7½%	Feb. 15, 2000		800		800	800
June 1, 1976	7½%	May 31, 1978	1,500	750	220	970	2,250
June 10, 1976	7½%	June 30, 1980		2,000	160	2,160	2,000
June 30, 1976	6½%	June 30, 1978	1,998	504	120	624	504
July 9, 1976	7½%	Aug. 15, 1981		2,501	70	2,571	2,501
July 30, 1976	6½%	July 31, 1978		2,755	85	2,840	2,755
Aug. 15, 1976	8%	Aug. 15, 1979	4,542	6,100	200	6,300	10,642
Do	8%	Aug. 15, 1986					
Do	8%	Aug. 15, 2001					
Aug. 31, 1976	6½%	Aug. 31, 1978	1,443	1,059	210	1,269	2,502
Sept. 14, 1976	6½%	Sept. 30, 1980		2,002	120	2,122	2,002
Sept. 30, 1976	6¼%	Sept. 30, 1978	1,681	822	355	1,177	2,503
Oct. 12, 1976	7%	Nov. 15, 1981		2,503	25	2,528	2,503
Nov. 1, 1976	5½%	Oct. 31, 1978	1,481	1,021	310	1,331	2,502
Nov. 15, 1976	6¼%	Nov. 15, 1979	3,994	2,000	300	2,500	5,994
Do	7%	Nov. 15, 1983			200		
Do	7½%	Feb. 15, 2000					
Nov. 30, 1976	5½%	Nov. 30, 1978	1,370	1,131	290	1,421	2,501
Dec. 7, 1976	5½%	Dec. 31, 1980		2,504	180	2,684	2,504
Dec. 31, 1976	5½%	Dec. 31, 1977	2,017	995	110	1,105	3,012
Jan. 6, 1977	6¼%	Feb. 15, 1982		2,501	190	2,691	2,501
Feb. 3, 1977	5½%	Jan. 31, 1979		2,504	335	2,839	2,504
Feb. 15, 1977	6½%	Feb. 15, 1980	2,068	3,700	300	4,000	5,768
Do	7½%	Feb. 15, 1984					
Do	7½%	Feb. 15, 2007					
Feb. 28, 1977	5½%	Feb. 28, 1979	1,515	989	175	1,164	2,504
Mar. 8, 1977	6½%	Mar. 31, 1981		2,250	550	2,800	2,250
Mar. 31, 1977	6%	Mar. 31, 1979	2,053	451	480	931	2,504
Apr. 4, 1977	7%	May 15, 1982		2,257	350	2,607	2,257
May 2, 1977	5½%	Apr. 30, 1979	1,469	2	400	402	1,471
May 15, 1977	7½%	Feb. 15, 1984	4,283	(400)	100	100	3,883
Do	7½%	Feb. 15, 2007					
May 31, 1977	6¼%	May 31, 1979	1,947	(66)	380	380	1,881
June 3, 1977	6¼%	June 30, 1981		2,001	500	2,501	2,001
June 30, 1977	6¼%	June 30, 1979	1,906	(126)	530	530	1,780
July 8, 1977	7½%	Aug. 15, 1992		1,501		1,501	1,501
Aug. 1, 1977	6¼%	July 31, 1979	1,451	1,055	590	1,645	2,506
Aug. 15, 1977	6¼%	Aug. 15, 1980	3,287	3,000	700	4,000	6,287
Do	7½%	Aug. 15, 1984			300		
Do	7½%	Feb. 15, 2007					
Aug. 31, 1977	6½%	Aug. 31, 1979	1,898	1,015	436	1,451	2,913
Sept. 7, 1977	6¼%	Sept. 30, 1981		2,511	450	2,961	2,511

SUMMARY TABLE FOR TREASURY DEBT MANAGEMENT OPERATIONS IN 1-YR BILLS

[Amounts in millions of dollars]

Year and quarter	Amount maturing domestically held	Net new money raised in domestic market	Additional money raised through direct sales to foreign accounts net of maturities	Total new money
1976:				
April to June	4,574	2,250	190	2,240
July to September	5,265	607	175	782
October to December	5,442	-----	429	429
1977:				
January to March	5,574	-----	277	277
April to June	7,313	(1,141)	364	364
July to September	5,537	-----	237	237

TREASURY DEBT MANAGEMENT OPERATIONS IN 1-YR BILLS

[Amounts in millions of dollars]

Payment date of new issue	Maturity date of new issue	Amount maturing domestically held	Net new money raised in domestic market	Additional money raised through direct sales to foreign accounts net of maturities	Total new money	Total new issues publicly held (excluding foreign official)
Apr. 6, 1976	Apr. 5, 1977	916	1,000	-----	1,000	1,916
May 4, 1976	May 3, 1977	1,092	750	150	900	1,842
June 1, 1976	May 31, 1977	1,225	500	20	520	1,725
June 29, 1976	June 28, 1977	1,341	-----	20	20	1,341
July 27, 1976	July 26, 1977	1,329	607	75	682	1,936
Aug. 24, 1976	Aug. 23, 1977	2,120	-----	50	50	2,120
Sept. 21, 1976	Sept. 20, 1977	1,816	-----	50	50	1,816
Oct. 19, 1976	Oct. 18, 1977	1,945	-----	28	28	1,945
Nov. 15, 1976	Nov. 15, 1977	1,890	-----	150	150	1,890
Dec. 14, 1976	Dec. 13, 1977	1,607	-----	251	251	1,607
Jan. 11, 1977	Jan. 10, 1978	1,643	-----	-----	-----	1,643
Feb. 8, 1977	Feb. 7, 1978	2,027	-----	175	175	2,027
Mar. 8, 1977	Mar. 7, 1978	1,904	-----	102	102	1,904
Apr. 5, 1977	Apr. 4, 1978	2,028	-----	136	136	2,028
May 3, 1977	May 2, 1978	1,953	(308)	128	128	1,645
May 31, 1977	May 30, 1978	1,957	(471)	50	50	1,486
June 28, 1977	June 27, 1978	1,375	(362)	50	50	1,013
July 26, 1977	July 25, 1978	1,720	-----	57	57	1,720
Aug. 23, 1977	Aug. 22, 1978	1,992	-----	50	50	1,992
Sept. 20, 1977	Sept. 19, 1978	1,825	-----	130	130	1,825