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FINANCIAL CONSEQUENCES OF OPEC INVESTMENT FUNDS

Under a wide range of circumstances, the members of the Organization of Petroleum Exporting Countries (OPEC) will accumulate vast holdings of financial assets over the next several years. Between now and 1980, OPEC members will have under a set of assumptions suggesting relatively low oil prices and high OPEC imports between \$35 and \$47 billion to invest annually and under assumptions allowing for high prices and low imports between \$47 and \$180 billion to invest each year. Not only will the size of their total holdings be quite large in absolute terms by 1980 -- roughly \$284 to \$657 billion -- but large in relative terms -- anywhere between 5.0 and 11 percent of the value of OECD country marketable assets -- under many sets of reasonable assumptions concerning the size of the world capital markets by 1980. Improper management of these funds will prove quite costly to the OPEC members and is potentially quite disruptive to world financial and exchange markets. The use of this wealth as a political weapon is not beyond the scope of imagination, although the so-called oil weapon is a much more powerful tool for disrupting the world economy.

Under a fixed exchange rate system, many countries could effectively neutralize the potentially damaging long run effects of conscious attempts by OPEC members to disrupt their capital or exchange markets by implementing offsetting monetary, fiscal or exchange rate policies. In that OPEC efforts at disruption through the use of their wealth can be thwarted, the most likely effect of their pursuing an economically irrational course of action would be that they would lose money. Under flexible exchange rates, disturbances in the exchange market resulting from abrupt and economically unjustified foreign currency trades will not effect the domestic economy in that they are likely to be



short-lived aberrations and because countries would still be able to run independent monetary-fiscal policies. Accordingly, it appears that OPEC members will most probably not view their wealth as a good tool for causing disruption.

It is a far more likely situation that whatever capital or foreign exchange market disruption occurs will be primarily a result of the normal problems of managing huge sums of money in relatively illiquid markets.

In the U.S. today, one of the major laments of professional money managers -- the men and women who head our nation's mutual funds and bank trust activities -- is the illiquidity of our capital markets. With respect to trading large (\$5-10 million) blocks of stock it is not infrequent that the combination of commissions and price concessions (discounts from market price in the case of sales and premia in the case of purchases) total five percent or more of the original market value of the stock and often have the market price of the stock changed for fairly long periods. More saliently, these are trades of stocks listed on the New York Stock Exchange, a financial market reputed to be one of the world's most efficient -- and are allegedly executed by the most sophisticated money managers in the world. Surely then the prospect of such large wealth concentrated in the hands of such a few countries may present some problems for the world's money and capital markets.

The key problem, however, is not a function of the investment inflows. Presuming OPEC states invest their funds on a fairly regular basis, the markets will be able to anticipate such events, discount them (evidence pertaining to anticipated large block trades suggest price changes of 2 to 3 percent) and absorb the incremental funds with little or no sudden and spectacular price effect in evidence. The central problem relates to the movement of these funds once they have already been invested. That is, while the incremental inflows may tend to be predictable, trading among securities or markets (e.g., moving funds from the U.S. stock market to the Eurobond market) cannot be properly anticipated. Accordingly, other traders in these markets will not be able

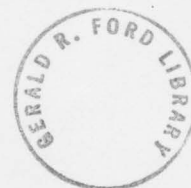


to arbitrage the markets, and because of the potentially massive volume of funds shifted and the supposedly limited borrowing capacity of arbitrageurs some phenomonally large, spontaneous and unjustified (i.e. random) price effects will occur.

If one is of the view that OPEC's finance ministers and their hirelings will behave economically rationally and prudently, one can forecast that they will attempt to minimize the price impacts of their trades principally because they will find them quite costly: no finance minister will want to report that he sold I.B.M. stock at 30 percent below the previous trading price so he could put his money to work in Kentucky Fried Computer.

There is no easy way to prevent economically irrational and irresponsible behavior in money management matters. It is not a crime to lose money in the securities markets purposely through reckless trading practices, however it is costly. One way to minimize the probability of such occurrences is to encourage OPEC countries to invest heavily in financial institutions such as brokerage houses, investment banks, and market-making operations so that they will have a stake in the smooth functioning of the markets and that disruptive activities will be doubly costly -- in the first instance to the value of their security portfolios and in the second instance to the value of their direct investment. Moreover, the encouragement of such investment need not take the form of special inducements, but merely the elimination of restrictions on foreign activity in financial markets, for example the New York Stock Exchange rule prohibiting foreign membership. It is also worth mentioning that the introduction of new competition along with the vast financial wealth of the OPEC states might bring the additional benefit of making capital markets generally more efficient than they currently are.

A second problem relating to OPEC wealth and world capital markets concerns the possibility of security price manipulation. Wealthy OPEC states will be able to manipulate security prices and probably remain beyond the detection of those national commissions and agencies whose role it is to prevent such activity or prosecute its



perpetrators. However, scope for manipulation exists today in many markets, especially the relatively less liquid ones, and the recommended method for eliminating it is not different from the prescription for dealing with the OPEC states' possibility of doing it: better market surveillance techniques and quicker action both to suspend trading in the affected securities or markets and to initiate judicial proceedings against the offenders.

Another important implication of OPEC wealth has to do with the international monetary system. A large portion of this wealth is likely to be quite mobile internationally. While one may question the likelihood of whether the oil countries will use their financial power for noneconomic purposes, there is little question that considerable amounts of oil funds may be expected to move in response to anticipation of exchange rate adjustments. A large increase in oil country funds would seem to assure the failure of any attempt to return to a sticky adjustable pay exchange rate system. However, even in the absence of an increase in oil country funds, international capital mobility has already reached a level at which maintenance of exchange rate parities which the market feels is inappropriate is virtually impossible for a sustained period of time. Thus the increase in oil country financial assets should serve to increase the need for maintaining a high degree of exchange rate flexibility, but this need already exists.

A final implication of OPEC wealth is that as the OPEC countries accumulate financial assets in OECD countries and elsewhere, their stake in the continued economic growth and stability of these countries will increase. To the extent that OPEC members are concerned about the aggregate size of their wealth, they will be significantly less likely to attempt to disrupt the economies where they hold assets. Therefore as their wealth increases, the probability of their pursuing policies designed to hamper other economies like cutting off their oil -- is likely to decline.



OPEC INVESTMENT FLOWS AND THE CAPITAL AND INTEREST
ACCOUNT OF THE U.S., EUROPEAN ECONOMIC COMMUNITY'S
AND JAPANESE BALANCE OF PAYMENTS

While the capital accounts of industrialized countries' balance of payments are likely to benefit from inflows of OPEC investment funds, their interest accounts are equally likely to become increasingly detrimental as interest payments are made on OPEC states' extremely large holdings of financial assets. This analysis probes this question in some detail and concludes that by 1980 a relatively large portion of developed countries' capital inflows from OPEC will be offset by interest outflows. The analysis has been conducted for a reasonably wide range of possible OPEC investment strategies and potential OPEC capital inflows.

Table 1 presents both high and low estimates of the OPEC revenues which will become available for investment purposes each year from 1974-1980. The estimates for each year include government oil related revenues minus imports plus interest payments of 8 percent on the total accumulation of financial assets as of the previous year. That is, Table 1 assumes reinvestment of interest and dividends. The high revenue estimates start at 66.5 billion dollars in 1974 and reach 170.9 billion dollars in 1980. On the other hand, the low revenue estimates start with 52.6 billion in 1974 and eventually reach 143.4 billion in 1980.^{1/}

The OPEC countries could allocate the revenues available for investment purposes according to several alternative investment strategies. The estimates in Table 2 assume that OPEC countries follow a "size of market" investment strategy. Under this strategy, the

^{1/} These estimates have been superceded, however, they fall within the range of the newer estimates; hence analysis based upon them provides similar insights.

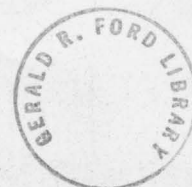


oil consuming countries receive funds from the OPEC countries based on the size of their domestic capital markets relative to the size of the world financial market. In Table 2 the high and low revenue estimates from Table 1 have been allocated to the U.S., Japan, the EEC and other countries on this basis. The other category includes most non-EEC OECD members as well as the Eurocurrency market. The estimates in this table and the ones which follow assume that the relative sizes of each capital market remain constant over the period 1974 through 1980. Under a size of market strategy, the U.S. would receive about 75% of the available OPEC investment funds. It is, however, unlikely that OPEC countries would invest such a large share of their investment funds in any one country.

It is considerably more probable that OPEC states will follow some type of "constrained size of market" investment strategy. The estimates in Table 3 are based on the assumption that the U.S. has been constrained so that it receives only 25% of available funds, while the remaining funds are allocated according to the relative size of each of the remaining capital markets.

Another possible method of allocating funds among domestic markets is a "new issue investment strategy." The estimates in Table 4 assume that each capital market receives funds from the OPEC nations in proportion to its share of the world market for new issues of financial assets.

Each of these three investment strategies--size of market, constrained investment, and new issues--would have a different impact on the interest account of the countries containing the four financial markets--U.S., Japan, EEC and others. Table 5 shows the projected impact on capital and interest account of a size of market investment strategy for each of these four markets. This table presents the estimated size of the capital inflows for each market using the data developed in Table 2, Possible Capital Inflows: Size of Market



Investment Strategy. The estimates were then used to project the annual size of the "Cumulative Investest" and the size of the "Interest Outflow" at 8 percent. A similar detailed presentation has been developed for the constrained investment strategy, Table 5 and the new issue investment strategy, Table 6.

Although both the "constrained size of market" investment strategy and the new issue proportional investment strategy appear to be considerably more reasonable strategies than the size of market approach, both tell similar stories: the interest account will worsen substantially in the future as a result of currently quite beneficial capital inflows.



Table I

Projected Annual OPEC Revenues Available for Investment*
(billions of dollars)

<u>Year</u>	<u>High Revenue Estimate</u>	<u>Low Revenue Estimate</u>
1974	66.5	52.6
1975	76.4	58.5
1976	92.5	73.6
1977	109.4	90.4
1978	128.7	107.5
1979	149.0	125.3
1980	170.9	143.4

*This includes government oil related revenues less imports plus interest payments of 8 percent on the previous year's accumulations of financial assets.



Table II

Possible Capital Inflows: Size of Market Investment Strategy
(billions of dollars)

	High Revenue Estimate				Low Revenue Estimate			
	U.S.	Japan	EEC	Other	U.S.	Japan	EEC	Other
1974	50.78	3.78	11.46	5.05	40.17	2.99	9.06	4.00
1975	58.34	4.35	13.16	5.81	44.67	3.33	10.08	4.45
1976	70.63	5.26	15.94	7.03	56.20	4.19	12.68	5.59
1977	83.54	6.22	18.85	8.31	68.99	5.14	15.57	6.87
1978	98.28	7.32	22.18	9.71	82.09	6.17	18.52	8.17
1979	113.74	8.48	25.66	11.32	95.64	7.13	21.58	9.52
1980	130.46	9.72	29.44	12.98	109.50	8.16	24.71	10.90



Table III

Possible Capital Inflows: Constrained Size of Market Investment Strategy (U.S.: 25%)
(billions of dollars)

	High Revenue Estimate				Low Revenue Estimate			
	U.S.	Japan	EEC	Other	U.S.	Japan	EEC	Other
1974	16.63	12.39	37.54	16.58	13.10	9.80	29.69	13.10
1975	19.10	14.24	43.17	19.02	14.60	10.90	33.02	14.57
1976	23.13	17.24	52.22	23.30	18.40	13.72	41.55	18.33
1977	27.35	20.39	61.76	27.24	22.59	16.84	51.00	22.50
1978	32.18	23.90	72.65	32.05	26.88	20.03	60.68	26.77
1979	37.22	27.76	84.08	37.09	31.31	23.35	70.70	31.19
1980	42.71	31.85	96.44	42.50	38.85	26.73	80.95	35.71



Table IV

Possible Capital Inflows: New Issue Investment Strategy
(billions of dollars)

	High Revenue Estimate				Low Revenue Estimate			
	U.S.	Japan	EEC	Other	U.S.	Japan	EEC	Other
1974	24.82	6.52	20.70	13.32	19.64	5.16	16.37	10.54
1975	28.52	7.49	23.78	15.30	21.84	5.74	18.21	11.72
1976	34.53	9.07	28.80	18.53	27.47	7.22	22.91	14.74
1977	40.84	10.73	34.06	21.91	33.73	8.86	28.13	18.10
1978	48.04	12.63	40.06	25.78	40.13	10.55	33.46	21.53
1979	55.60	14.61	46.37	29.83	46.76	12.29	38.99	25.09
1980	63.78	16.76	53.19	34.22	53.53	14.07	44.64	28.72





Table V

Possible Interest Account Impacts: Size of Market Investment Strategy
(billions of dollars)

	High Revenue Estimate			Low Revenue Estimate		
	Inflow	Cumulative Investment	8% Interest Payment Interest Outflow	Inflow	Cumulative Investment	8% Interest Payment Interest Outflow
<u>U.S.</u>						
1974	50.78	50.78	4.06	40.17	40.17	3.21
1975	58.34	109.12	8.73	44.67	84.84	6.79
1976	70.63	179.75	14.38	56.20	141.04	11.28
1977	83.54	263.29	21.06	68.99	210.03	16.80
1978	98.28	361.57	28.93	82.09	292.12	23.37
1979	113.74	475.31	38.02	95.64	387.76	31.02
1980	130.46	605.77	48.46	109.50	497.26	39.78
<u>Japan</u>						
1974	3.78	3.78	.30	2.99	2.99	.24
1975	4.35	8.13	.65	3.33	6.32	.51
1976	5.26	13.39	1.07	4.19	10.51	.84
1977	6.22	19.61	1.57	5.14	15.65	1.25
1978	7.32	26.93	2.15	6.17	21.82	1.75
1979	8.48	35.41	2.83	7.13	28.95	2.32
1980	9.72	45.13	3.61	8.16	37.11	2.97
<u>EEC</u>						
1974	11.46	11.46	.92	9.06	9.06	.72
1975	13.16	24.62	1.97	10.08	19.14	1.53
1976	15.94	40.56	3.24	12.68	31.82	2.55
1977	18.85	59.41	4.75	15.57	47.39	3.79
1978	22.18	81.59	6.53	18.52	65.91	5.27
1979	25.66	107.25	8.58	21.58	87.49	7.00
1980	29.44	136.69	10.94	24.71	112.20	8.98

Table V (cont'd.)

Possible Interest Account Impacts: Size of Market Investment Strategy
(billions of dollars)

	High Revenue Estimate			<u>Other</u>	Low Revenue Estimate		
	Inflow	Cumulative Investment	8% Interest Payment Interest Outflow		Inflow	Cumulative Investment	8% Interest Payment Interest Outflow
1974	5.05	5.05	.40		4.00	4.00	.32
1975	5.81	10.86	.88		4.45	8.45	.68
1976	7.03	17.89	1.43		5.59	14.04	1.12
1977	8.31	26.20	21.0		6.87	20.91	1.67
1978	9.71	35.91	2.87		8.17	29.08	2.33
1979	11.32	47.23	3.78		9.52	38.60	3.09
1980	12.98	60.21	4.82		10.90	49.50	3.96



Table VI

Possible Interest Account Impact: Constrained Size of Market Investment Strategy (U.S.=25%)
(billions of dollars)

	High Revenue Estimate			Low Revenue Estimate		
	Inflow	Cumulative Investment	8% Interest Payment Interest Outflow	Inflow	Cumulative Investment	8% Interest Payment Interest Outflow
<u>U.S.</u>						
1974	16.63	16.63	1.33	13.10	13.10	1.05
1975	19.10	35.73	2.85	14.60	27.70	2.30
1976	23.13	58.86	4.70	18.40	46.10	3.69
1977	27.35	86.21	6.90	22.59	68.69	5.50
1978	32.18	118.39	9.47	26.88	95.57	7.65
1979	37.22	155.61	12.45	31.31	126.88	10.15
1980	42.71	198.32	15.87	35.85	162.73	13.02
<u>Japan</u>						
1974	12.39	12.39	0.99	9.80	9.80	0.78
1975	14.24	26.63	2.13	10.90	20.70	1.66
1976	17.24	43.87	3.51	13.72	34.42	2.75
1977	20.39	64.26	5.14	16.84	51.26	4.10
1978	23.98	88.21	7.06	20.03	71.29	5.70
1979	27.76	115.97	9.28	23.35	94.64	7.57
1980	31.85	147.82	11.83	26.73	121.37	9.71
<u>EEC</u>						
1974	37.54	37.54	3.00	29.69	29.69	2.38
1975	43.17	80.71	6.46	33.02	62.71	5.02
1976	52.22	132.93	10.63	41.55	104.26	8.34
1977	61.76	194.69	15.58	51.00	155.26	12.42
1978	72.65	267.34	21.39	60.68	215.94	17.28
1979	84.08	351.42	28.11	70.70	286.64	22.93
1980	96.44	447.86	35.83	80.95	367.59	29.41



Table VI (cont'd.)

Possible Interest Account Impact: Constrained Size of Market Investment Strategy (U.S.=25%)
(billions of dollars)

	High Revenue Estimate			<u>Other</u>	Low Revenue Estimate		
	Inflow	Cumulative Investment	8% Interest Payment Interest Outflow		Inflow	Cumulative Investment	8% Interest Payment Interest Outflow
1974	16.56	16.56	1.32		13.10	13.10	1.05
1975	19.02	35.58	2.85		14.57	27.67	2.21
1976	23.30	58.88	4.71		18.33	46.00	3.68
1977	27.24	86.12	6.89		22.50	68.50	5.48
1978	32.05	118.17	9.45		26.77	95.27	7.62
1979	37.09	155.26	12.42		31.19	126.46	10.12
1980	42.50	197.76	15.82		35.71	162.17	12.97



Table VII

Possible Interest Account Impact: New Issue Investment Strategy
(billions of dollars)

	High Revenue Estimate			Low Revenue Estimate		
	Inflow	Cumulative Investment	8% Interest Payment Interest Outflow	Inflow	Cumulative Investment	8% Interest Payment Interest Outflow
<u>U.S.</u>						
1974	24.82	24.82	1.99	19.64	19.64	1.57
1975	28.52	53.34	4.27	21.84	41.48	3.32
1976	34.53	87.87	7.03	27.47	68.95	5.52
1977	40.84	128.71	10.30	33.37	102.68	8.21
1978	48.04	176.75	14.14	40.13	142.81	11.42
1979	55.60	232.35	18.59	46.76	189.57	15.17
1980	63.78	296.13	23.69	53.53	243.10	19.45
<u>Japan</u>						
1974	6.52	6.52	.52	5.16	5.16	.41
1975	7.49	14.01	1.12	5.74	10.90	.87
1976	9.07	23.08	1.85	7.22	18.12	1.45
1977	10.73	33.81	2.70	8.86	26.98	2.16
1978	12.63	46.44	3.72	10.55	37.53	3.00
1979	14.61	61.05	4.88	12.29	49.82	3.99
1980	16.76	77.81	6.22	14.07	63.89	5.11
<u>EEC</u>						
1974	20.70	20.70	1.66	16.37	16.37	1.31
1975	23.78	44.48	3.56	18.21	34.58	2.77
1976	28.80	73.28	5.86	22.91	57.49	4.60
1977	34.06	107.34	8.59	28.13	85.62	6.85
1978	40.06	147.40	11.79	33.46	119.08	9.53
1979	46.37	193.77	15.50	38.99	158.07	12.65
1980	53.19	246.96	19.76	44.64	202.71	16.22



Table VII (cont'd.)

Possible Interest Account Impact: New Issue Investment Strategy
(billions of dollars)

	High Revenue Estimate			<u>Other</u>	Low Revenue Estimate		
	Inflow	Cumulative Investment	8% Interest Payment Interest Outflow		Inflow	Cumulative Investment	8% Interest Payment Interest Outflow
1974	13.32	13.32	1.07		10.54	10.54	.84
1975	15.30	28.62	2.29		11.72	22.26	1.78
1976	18.53	47.15	3.77		14.74	37.00	2.96
1977	21.91	69.06	5.52		18.10	55.10	4.40
1978	25.78	94.84	7.59		21.53	76.63	6.13
1979	29.83	124.67	9.97		25.09	101.72	8.14
1980	34.22	158.89	12.71		28.72	130.44	10.44



SIZE AND POSSIBLE ALLOCATIONS OF
OPEC EXCESS REVENUE RELATIVE TO
WORLD CAPITAL MARKETS FOR
1974 and 1980

Table 1 shows the projected magnitude of OPEC investment funds (current account surpluses) for the years 1974 through 1980 under several alternative assumptions concerning the price of oil and imports.

For our purposes, world capital markets were taken as the capital markets in OECD countries plus the Eurocurrency or international market. This group of countries was broken down into five sectors: the U.S., Japan, the European Economic Community, the International, and other OECD countries. Moreover, for each sector, the capital market was separated into three categories: equity, bonds, and short-term capital.

Tables 2A and 2B show the absolute and relative sizes of world capital markets in 1972. Equity was taken as the book value of all publicly held corporations; this is likely to bear a reasonably close relationship to market value, but probably understates market value slightly. Bonds include all public and private long-term debt valued at nominal value. Short-term comprised the short-term liabilities of the entire non-financial sector to the financial sectors. Of great interest is that in 1972, the size of the world capital market was roughly \$2.9 trillion and that the U.S. capital market accounted for nearly seventy-five percent of the value of world capital markets.

Tables 3A and 3B show the absolute and relative volume of new issues (or net additions) in each of these capital markets in 1972. In that year, slightly more than \$245 billion was raised and the U.S. share of this was approximately 37 percent.



Three rational investment strategies -- each of which has foundations in modern portfolio theory -- are assumed to be relevant for OPEC investors, and subsequent analysis is based on these. The first -- the size of market investment strategy -- suggests that OPEC countries invest their funds in proportion to the size of the relevant capital market. The second -- the new issue investment strategy -- requires that funds are invested in proportion to the volume of new issues in a particular market. The third is a hybrid strategy which assumes that funds will be invested according to the relative size of the market but constrains investment in the U.S. to be no greater than 25 percent of investable funds. This may be dictated by political considerations.

In addition to capital market investments, OPEC members are likely to invest a portion of their investable funds in direct investments and use some portion for foreign aid. For illustrative purposes, it was assumed that 15 percent of their investable funds will be used for direct investment, including investment in real estate, and 5 percent will be used for foreign aid.

Tables 4, 5, and 6 show the proportion of available funds which OPEC members will invest in the various financial markets under each of the three alternative investment strategies and assuming direct investment of 15 percent and foreign aid of 5 percent.

Tables 7A and 7B show, for alternative projections of OPEC revenues, the magnitude of investment funds flowing to each financial market under the size of market investment strategy in 1974 (A) and 1980 (B). Tables 8A and 8B show inflows into the financial market for 1974 and 1980, respectively, if the new issue investment strategy is followed. Finally Tables 9A and 9B show inflows if a constrained (U.S. = 25%) size of market investment strategy is pursued.

For 1974, the U.S. may experience capital inflows from OPEC countries in the range of nearly \$12 to as



much as \$28 billion depending on the investment strategy pursued and the precise magnitude of OPEC revenues. For 1980, the three revenue projections and assumed investment strategies reveal that capital inflows may range from \$9 billion to \$108 billion. In short, under a wide variety of projections concerning OPEC revenue and under three different but quite rational investment strategies, the U.S. should experience substantial capital inflows from OPEC members over the remainder of the decade.

In an effort to develop some idea as to the possible capital market impacts of these inflows, Tables 10A and 10B have been constructed. Table 10A relates the possible OPEC investment flows to the projected size of each capital market in 1974 under alternative revenue projections and investment strategies. For these purposes, it was assumed that the aggregate financial market in each sector would grow at 10 percent annually. Table 10B relates OPEC investment flows to the projected size of financial markets in 1980. (Once again 10 percent annual growth was assumed.) For 1974, OPEC flows into the U.S. may approximate .4 to 1.0 percent of the projected size of the market, depending on revenue estimates and investment strategy. For 1980, OPEC nations' investment inflows may equal anywhere from .2 to 2.3 percent of the U.S. market's projected size.

Finally, Table 11 relates OPEC investment inflows under each of the three revenue projections to the projected flows of new issues (a 10 percent growth rate is again assumed) for each of the three alternative investment strategies. One of the prime highlights of this table is that OPEC inflows relative to U.S. new issues may approximate 10.5 to 25.1 percent, depending on revenue projections and investment strategies.

In sum, no matter how one views the situation, OPEC members are likely to become quite important investors and will be a substantial force in world capital markets in years to come.



TABLE 1

Projected OPEC Current Account, 1974-80^{1/}
(Bil. of \$)

	"High" ^{2/}	"Moderate" ^{2/}	"Low" ^{2/}
1974	46.76	46.76	46.76
1975	32.86	36.26	31.51
1976	60.86	42.81	35.16
1977	77.13	50.43	39.21
1978	105.54	58.75	43.78
1979	136.37	56.55	36.54
1980	180.89	61.96	35.14

^{1/} Oil Export revenues less goods and services imports plus interest income on prior year's stock of financial assets at 8 percent.

^{2/} Projection Assumptions

	"High"			"Moderate"			"Low"		
	Price	Exports	Imports	Price	Exports	Imports	Price	Exports	Imports
1974	\$7.54	28.3	\$32.4	\$7.54	28.3	\$32.4	7.54	28.3	\$32.4
1975	7.54	30.6	56.4	7.95	30.7	57.9	7.54	29.9	55.8
1976	9.03	34.8	61.5	8.36	33.0	65.8	7.54	31.4	58.8
1977	10.52	37.9	80.9	8.77	35.4	74.3	7.54	32.9	61.7
1978	12.02	40.2	89.5	9.18	37.8	83.3	7.54	34.5	64.7
1979	15.51	44.4	107.7	8.50	40.1	88.0	6.25	36.0	62.8
1980	15.00	47.6	117.8	8.00	42.6	87.1	5.00	37.6	55.7

Price - Government Revenue in dollars Exports - OPEC oil exports in mbd Imports - OPEC goods and services imports in bil of dollars



Table 2A
Size of World Capital Markets: 1972 1/
(Billions of Dollars)

	<u>U.S.</u>	<u>Japan</u>	<u>EEC</u>	<u>International</u> ²	<u>Other</u> ³	<u>Total</u>
Equity	1168.500	36.930	109.950	-	16.418	1331.798
Bonds	633.971	97.450	185.889	33.000	54.640	1004.950
Short-term	394.041	29.563	65.083	100.000	15.632	604.319
TOTAL	2196.512	163.943	360.922	133.000	86.690	2941.067

Table 2B
Relative Size of World Capital Markets: 1972
(Percent)

	<u>U.S.</u>	<u>Japan</u>	<u>EEC</u>	<u>International</u>	<u>Other</u>	<u>Total</u>
Equity	39.7	1.25	3.76	-	.55	45.26
Bonds	21.5	3.31	6.39	1.12	1.85	34.17
Short-term	13.4	1.00	2.24	3.40	.53	20.57
TOTAL	74.6	5.56	12.39	4.52	2.93	100.00

1/ Source: OECD

2/ Eurocurrency Markets

3/ Includes all other OECD countries



Table 3A
 New Capital Market Issues, 1972 ^{1/}
 (Billions of Dollars)

	<u>U.S.</u>	<u>Japan</u>	<u>EEC</u>	<u>International</u>	<u>Other</u>	<u>Total</u>
Equity	13.044	4.635	7.588	-	4.278	29.545
Bonds	43.773	19.495	29.639	4.276	11.292	108.475
Short-term	35.100	N/A	43.761	25.000	3.922 ²	107.783
TOTAL	91.917	24.130	80.988	29.276	19.492	245.803

Table 3B
 Relative New Capital Market Issues, 1972
 (Percent)

	<u>U.S.</u>	<u>Japan</u>	<u>EEC</u>	<u>International</u>	<u>Other</u>	<u>Total</u>
Equity	5.30	1.88	3.08	-	1.74	12.00
Bonds	17.80	7.93	12.05	1.73	4.59	44.10
Short-term	14.27	N/A	17.87	10.17	1.59	43.90
TOTAL	37.37	9.81	33.00	11.90	7.92	100.00

^{1/} Source: OECD

^{2/} Data incomplete



Table 4
 Distribution of Oil Revenues
 Size of Market Investment Strategy
 (Percent)

	<u>U.S.</u>	<u>Japan</u>	<u>EEC</u>	<u>International</u>	<u>Other</u> ¹	<u>Non-Financial</u>
Equity	31.76	1.00	3.01	-	.44	-
Bonds	17.20	2.65	5.11	.90	1.48	-
Short-term	10.72	.80	1.79	2.72	.42	-
Direct Investment	-	-	-	-	-	15.0
Foreign Aid	-	-	-	-	-	5.0
TOTAL	59.68	4.45	9.91	3.62	2.34	20.0

^{1/} Includes all other OECD countries



Table 5
 Distribution of Oil Revenues
 New Issue Investment Strategy
 (Percent)

	<u>U.S.</u>	<u>Japan</u>	<u>EEC</u>	<u>International</u>	<u>Other</u> ¹	<u>Non-Financial</u>
Equity	4.24	1.50	2.46	-	1.39	-
Bonds	14.24	6.34	9.64	1.38	3.67	-
Short-term	11.42	N/A	14.30	8.14	1.27	-
Direct Investment	-	-	-	-	-	15.0
Foreign Aid	-	-	-	-	-	5.0
TOTAL	29.9	7.84	26.4	9.52	6.33	20.00

¹/ Includes all other OECD countries



Table 6
 Distribution of Oil Revenues
 Constrained Size of Market Strategy - U.S. = 25%
 (Percent)

	<u>U.S.</u>	<u>Japan</u>	<u>EEC</u>	<u>International</u>	<u>Other</u> ¹	<u>Non- Financial</u>
Equity	13.30	2.73	8.10	-	1.20	-
Grants	7.20	7.20	13.75	2.43	4.04	-
Short-term	4.50	2.18	4.82	7.39	1.16	-
Direct In- vestment	-	-	-	-	-	15.0
Foreign Aid	-	-	-	-	-	5.0
TOTAL	25.0	12.11	26.66	9.82	6.40	20.0

¹ Includes all other OECD countries



Table 7A
 Allocation of Financial Investment Funds
 Size of Market Investment Strategy, 1974
 (Billions of Dollars)

	<u>U.S.</u>	<u>Japan</u>	<u>EEC</u>	<u>International</u>	<u>Other</u>
<u>High Revenue Est.</u>					
Equity	14.84	.47	1.41	0.	0.21
Bonds	8.04	1.24	2.39	0.42	0.69
Short-term	5.01	0.38	0.84	1.27	0.20
TOTAL	27.90	2.08	4.63	1.70	1.09
<u>Moderate Revenue Est.</u>					
Equity	15.30	0.47	1.41	0	0.21
Bonds	8.05	1.26	2.39	0.42	0.69
Short-term	5.01	0.38	0.84	1.26	0.21
TOTAL	28.35	2.11	4.63	1.68	1.11
<u>Low Revenue Est.</u>					
Equity	15.30	0.47	1.41	0	0.21
Bonds	8.05	1.26	2.39	0.42	0.69
Short-term	5.01	0.38	0.84	1.26	0.21
TOTAL	28.35	2.11	4.63	1.68	1.11



Table 7B
Allocation of Financial Investment Funds
Size of Market Strategy, 1980
(Billions of Dollars)

	<u>U.S.</u>	<u>Japan</u>	<u>EEC</u>	<u>International</u>	<u>Other</u>
<u>High Revenue Est.</u>					
Equity	57.45	1.84	5.45	0.00	0.80
Bonds	31.11	4.79	9.26	1.63	2.63
Short-term	19.39	1.44	3.27	4.92	0.76
TOTAL	107.95	7.78	17.97	6.55	4.23
<u>Moderate Revenue Est.</u>					
Equity	19.68	0.62	1.87	0.00	0.27
Bonds	10.66	1.64	3.17	0.56	0.92
Short-term	6.64	0.49	1.11	1.69	0.26
TOTAL	36.97	2.76	6.14	2.24	1.45
<u>Low Revenue Est.</u>					
Equity	11.16	0.35	1.06	0.00	0.16
Bonds	6.04	0.93	1.80	0.32	0.52
Short-term	3.77	0.28	0.63	0.96	0.15
TOTAL	20.97	1.56	3.49	1.27	0.82



Table 8A
 Allocation of Financial Investment Funds
 New Issue Investment Strategy, 1974
 (Billions of Dollars)

	<u>U.S.</u>	<u>Japan</u>	<u>EEC</u>	<u>International</u>	<u>Other</u>
<u>High Revenue Est.</u>					
Equity	1.98	0.70	1.15	-	0.65
Bonds	6.66	2.96	4.51	0.65	1.71
Short-term	5.34	N/A	6.69	3.81	0.60
TOTAL	13.98	3.67	12.34	4.46	2.96
<u>Moderate Revenue Est.</u>					
Equity	1.98	0.70	1.15	-	0.65
Bonds	6.66	2.97	4.50	0.65	1.71
Short-term	5.34	N/A	6.69	3.80	0.59
TOTAL	13.98	3.67	12.34	4.45	2.96
<u>Low Revenue Est.</u>					
Equity	1.98	0.70	1.15	-	0.65
Bonds	6.66	2.97	4.50	0.65	1.71
Short-term	5.34	N/A	6.69	3.80	0.59
TOTAL	13.98	3.67	12.34	4.45	2.96



Table 8B
 Allocation of Financial Investment Funds
 New Issue Investment Strategy, 1980
 (Billions of Dollars)

	<u>U.S.</u>	<u>Japan</u>	<u>EEC</u>	<u>International</u>	<u>Other</u>
<u>High Revenue Est.</u>					
Equity	7.67	2.72	4.45	-	2.51
Bonds	25.76	11.47	17.44	2.50	6.64
Short-term	20.66	N/A	25.87	14.73	2.30
TOTAL	54.09	14.19	47.76	17.22	11.45
<u>Moderate Revenue Est.</u>					
Equity	2.63	0.93	1.52	-	0.86
Bonds	8.82	3.93	5.97	0.86	2.27
Short-term	7.07	N/A	8.86	5.04	0.79
TOTAL	18.53	4.86	16.36	5.90	3.92
<u>Low Revenue Est.</u>					
Equity	1.49	0.53	0.87	-	0.49
Bonds	5.00	2.23	3.39	0.48	1.29
Short-term	4.01	N/A	5.02	2.86	0.45
TOTAL	10.50	2.76	9.27	3.34	2.23



Table 9A

Allocation of Financial Investment Funds: Constrained
 Size of Market Investment Strategy, 1974
 (bill. of \$) (U.S. - 25%)

	<u>U.S.</u>	<u>Japan</u>	<u>EEC</u>	<u>International</u>	<u>Other</u>
<u>High Revenue Est.</u>					
Equity	6.22	1.28	3.79	-	0.57
Bonds	3.37	3.37	6.43	1.14	1.89
Short-term	2.10	1.02	2.25	3.45	0.54
TOTAL	11.69	5.66	12.47	4.59	3.00
<u>Moderate Revenue</u>					
Equity	6.22	1.28	3.78	-	0.56
Bonds	3.37	3.37	6.43	1.14	1.89
Short-term	2.11	1.02	2.25	3.46	0.54
TOTAL	11.69	5.67	12.47	4.59	2.99
<u>Low Revenue Est.</u>					
Equity	6.22	1.28	3.78	-	0.56
Bonds	3.37	3.37	6.43	1.14	1.89
Short-term	2.11	1.02	2.25	3.46	0.54
TOTAL	11.69	5.67	12.47	4.59	2.99



Table 9B

Allocation of Financial Investment Funds: Constrained
 Size of Market Investment Strategy, 1980
 (billions of dollars)

	<u>U.S.</u>	<u>Japan</u>	<u>EEC</u>	<u>International</u>	<u>Other</u>
<u>High Revenue Est.</u>					
Equity	24.06	4.94	14.65	-	2.17
Bonds	13.02	13.02	24.87	4.40	7.30
Short-term	8.14	3.94	8.72	13.37	2.10
Total	45.23	21.90	48.24	17.77	11.57
<u>Moderate Revenue Est.</u>					
Equity	8.24	1.69	5.02	-	0.74
Bonds	4.46	4.46	8.52	1.50	2.50
Short-term	2.79	1.35	2.99	4.58	0.72
TOTAL	15.49	7.50	16.52	6.08	3.97
<u>Low Revenue Est.</u>					
Equity	4.67	0.96	2.85	-	0.42
Bonds	2.53	2.53	4.83	0.86	1.42
Short-term	1.58	0.77	1.69	2.60	0.41
TOTAL	8.79	4.25	9.37	3.45	2.25



Table 10A

Investment Flows Relative to Market Size: 1974
(Percent)

	<u>U.S.</u>	<u>Japan</u>	<u>EEC</u>	<u>International</u>	<u>Other</u>
<u>High Revenue Estimate</u>					
Size of Market Investment Strategy	1.05	1.05	1.05	1.05	1.05
New Issues Investment Strategy	0.53	1.85	2.83	2.77	2.82
Constrained Size of Market Strategy	0.44	2.86	2.86	2.86	2.86
<u>Moderate Revenue Estimate</u>					
Size of Market Investment Strategy	1.06	1.06	1.06	1.06	1.06
New Issues Investment Strategy	0.52	1.86	2.85	2.77	2.82
Constrained Size of Market Strategy	0.44	2.86	2.86	2.86	2.86
<u>Low Revenue Estimate</u>					
Size of Market Investment Strategy	1.06	1.06	1.06	1.06	1.06
New Issues Investment Strategy	0.52	1.86	2.85	2.77	2.82
Constrained Size of Market Strategy	0.44	2.86	2.86	2.86	2.86



Table 10B

Investment Flows Relative to Market Size: 1980
(Percent)

	<u>U.S.</u>	<u>Japan</u>	<u>EEC</u>	<u>International</u>	<u>Other</u>
<u>High Revenue Estimate</u>					
Size of Market Strategy	2.29	2.21	2.32	2.29	2.28
New Issues Investment Strategy	1.15	4.04	6.18	6.05	6.17
Constrained Size of Market Investment Strategy	0.96	6.24	6.24	6.26	6.24
<u>Moderate Revenue Estimate</u>					
Size of Market Strategy	0.79	0.78	0.79	0.79	0.78
New Issues Investment Strategy	0.39	1.38	2.15	2.07	2.11
Constrained Size of Market Investment Strategy	0.55	2.14	2.14	2.14	2.14
<u>Low Revenue Estimate</u>					
Size of Market Strategy	0.44	0.44	0.45	0.44	0.44
New Issues Investment Strategy	0.22	0.78	1.20	1.17	1.20
Constrained Size of Market Investment Strategy	0.18	1.21	1.21	1.21	1.21



Table 11
Investment Flows Relative to
New Capital Market Issues, 1974
(Percent)

	<u>U.S.</u>	<u>Japan</u>	<u>EEC</u>	<u>International</u>	<u>Other</u>
<u>High Revenue Est.</u>					
Size of Market Investment Strategy	<u>25.09</u>	7.13	4.73	4.78	0.37
New Issue Investment Strategy	12.57	12.56	12.60	12.58	12.54
Constrained Size of Market Strategy	10.51	19.40	12.73	12.96	12.71
<u>Moderate Revenue Est.</u>					
Size of Market Investment Strategy	25.50	7.22	4.73	4.76	0.37
New Issue Investment Strategy	12.57	12.59	12.60	12.57	12.53
Constrained Size of Market Strategy	10.51	19.41	12.72	12.97	12.69
<u>Low Revenue Est.</u>					
Size of Market Investment Strategy	25.50	7.22	4.73	4.76	0.37
New Issue Investment Strategy	12.57	12.59	12.60	12.57	12.53
Constrained Size of Market Strategy	10.51	19.41	12.72	12.97	12.69



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✕ L An Energy Financial Cooperation Facility

This paper assumes that:

1. The oil producing countries (OPC) will wish to divide their assets among instruments providing security, yield and liquidity.
2. The OPC, with respect to a portion of their funds, may wish to take advantage of an international facility for investing oil revenues among oil consuming countries (OCC) to avoid the politics of picking and choosing countries for investment and to gain some international approval for their investments.
3. It will be impossible to operate an international agency with wide decision-making powers because of the wide divergence of interest between OPC and OCC and that any international investment facility would have to operate under rules agreed in advance.
4. The OPC should be made to choose between security of investment with low yield and market yield with uncertainty concerning such risks as blocking, depreciation and expropriation (although an exception could be made for investments in less developed countries).
5. It is undesirable to establish another large well financed international bureaucracy.



Based on these assumptions the following Energy Financial Cooperation Facility could be established:

I. Structure

(a) The Three Windows

The Facility could be established as an adjunct to an existing agency such as the IMF or BIS. The Facility would have three "windows." (1) banking, (2) equity, and (3) insurance.

The staffs of the administering agency would be responsible for making the arithmetic calculations called for by the agreement and for performing any other administrative tasks. No Board of Governors or other decision-making structure would be created.

(b) Membership

Any OPC or OCC that is a member of the IMF (and imports oil directly from an OPC) could register as a member. LDCs would have a special category of membership that would exempt them from sharing insurance risks.

(c) Deposits by Oil Producing Countries

OPC could deposit all or part of their oil revenues into either the banking or equity windows of the Facility. The account would be denominated in the currency deposited. Deposits held by the Facility would not be subject to tax, would enjoy immunity from judicial process, shall be immune from requisition, confiscation, expropriation, blocking, or any other form of seizure by executive or legislative action, and would be free from any restrictions, regulation controls and moratoria of any nature.



II. The Banking Window

(a) Terms of Deposits

Deposits in the banking window by OPC members would earn Eurodollar interest rates and could be withdrawn only after an agreed fixed period of years, say, 10 years. However, a portion of the deposits attributable to the LDC share of oil imports could earn interest at a lower rate, say, 3 percent, and have a longer maturity, say, 15 years.

(b) Determination of Oil Import Costs

The Facility would determine the annual oil import costs of each OCC member based on a formula which would take into account imports over a base period plus a growth factor.

(c) Lending of Deposits

The Facility would lend all of the funds deposited in the account to the OCC members in proportion to their oil import costs to total oil import costs of all OCC members. Any member could refuse an allocation of a deposit and its share would be reallocated among remaining members.

(d) Terms of Loans

Loans by the Facility would be denominated in the currency of deposit, interest would be at the Eurodollar rate, and would be repayable in ten years; loans to LDC consumer members would be at the 3 percent rate and have a 15-year maturity.

(e) Prepayments and Extensions

Any member borrowing from the Facility would have the right to prepay any loan or extend repayment of any maturity by five years if it formally represents that it is in serious balance of payments difficulties.



(f) Responsibility for Repayment

The Facility would not be responsible for the repayment of any loan. Repayment would be the sole responsibility of the borrowing country. However, developed country consumer members that borrow from the Facility would agree to repay up to one-half of any default by a developing country member borrower with the loss shared among the developed countries in proportion to their total borrowing from the facility.

III. The Equity Window

- (a) Until invested in equity securities, deposits of equity funds would be held in liquid short-term government securities of members on a competitive bid basis. Developed country OCC and OPC members would guarantee the liquidity and return these securities with developed countries bearing half the loss in proportion to IMF quotas and the OPC bearing the remainder in proportion to oil revenues.
- (b) Each member could establish a domestic agency to receive equity investments from the Facility. The domestic agency would be responsible for presenting equity investment proposals to the Facility for investment in the domestic agency or in private enterprises. The Staff would evaluate the technical economic merits of any proposal but could not made recommendations.



- (c) Decisions on whether to invest would be made solely by the depositor.
- (d) Depositors making equity investments would exercise all the normal incidence of ownership provided, however, that equity investments would have to be held for ten years unless earlier liquidation is approved by the domestic agency.

IV. The Insurance Window

- (a) Any equity investment made under the equity window in a less developed country would be eligible for insurance for political risks -- expropriation, inconvertibility or armed conflict.
- (b) A fixed premium would be set that would be reviewed by the signatories every five years.
- (c) Losses would be shared one-half by developed member countries in proportion to IMF quotas and one-half by the OPC in proportion to oil revenues.
- (d) Any country that expropriated property of any foreign investor without prompt, adequate and effective compensation, would not be eligible for loans or equity investments from the Facility.



LIMITED OFFICIAL USE

L. A JOINT PRODUCER-CONSUMER INVESTMENT AGENCY
(The Cooperative Resource Preservation Fund)

Groups of governments could establish an investment fund or bank as a means of investing some portion of the surplus funds of the oil-producing states in such a way as to:

- reduce the impact of the recent petroleum price increases on the overall payments positions of the consuming countries.
- help to maintain a stable world payments equilibrium, and
- reduce the pressure for competitive depreciation and restrictions on trade and capital flows.

Conceivably such an institution could be created by:

- a group of oil-consuming countries such as OECD
- a group of oil-producing countries such as OPEC or OAPEC (Organization of Arab Petroleum Exporting Countries)
- by a group composed of both producer and consumer countries



Although all three types of organizations are conceivable, it seems likely that the Arab states would be more willing to place funds with an institution in which they had a sub-

stantial degree of control, while consumer countries would feel the need to have a voice in the operation. This memorandum, therefore, focuses on a joint agency.

Probable Lending Requirements

A multilateral investment agency could be set up to invest funds in a wide variety of ways:

- balance of payments loans to governments adversely affected by the oil price increase
- a diversified portfolio of private equity and both private and public debt instruments
- real estate and other property
- development loans to LDC's
- development projects within the oil-producing countries themselves

Any multilateral investment agency would have to offer terms and conditions attractive enough to persuade the oil-producing states to place with it a significant portion of their surplus funds. It would have to provide lenders with a high degree of safety for their investments, a reasonable income and probably some type of guarantee as to capital values.

Some Arab states have implied that their major concerns in investing their funds are:

- to minimize the risk of expropriation, restriction by host governments or of their being used as



leverage to influence Arab policies and
-to maintain the purchasing power of their
assets in terms of the price of industrial
goods.

In the past these states have apparently followed quite conservative investment policies, using a number of investment advisors and investment bankers. They have attached a great deal of importance to anonymity.

Possible Advantages of a Multilateral Agency

Arab states may find it virtually impossible to invest the volume of funds likely to become available to them in the near future in such a way as to maintain the anonymity which they have sought. While the extent of their investments in a multilateral agency would obviously be known, governments of consumer states which had accepted membership in such an agency would find it extremely difficult to subject the agency's investments to blocking or other forms of special restrictions. It would be difficult for a country to restrict the assets of a particular oil-producing country and difficult for a single consumer country to take restrictive action without affecting the interests of other consumers. Consequently, an agency of this type might provide the Arab states with a higher degree of security and political safety than could be achieved through normal investment channels.



The economic risk would also be reduced by extending credits thru a multilateral agency backed by guarantees of the governments of major industrial countries.

A joint agency would serve as evidence of cooperation between producer and consumer states and thus could have political significance. By providing a forum for dialogue between oil importers and oil exporters it might even serve to moderate some of the more extreme demands with respect to the price of petroleum. It might also contribute to the willingness of the producing states to produce oil in the volume required for the economic health of the world.

There has been some concern that Arab governments might, for either economic or political reasons, transfer funds among countries in a destabilizing manner. To the extent that such risks exist, they might be reduced if funds were invested in a multilateral investment agency. Such an agency might also help to channel capital in such a way as to facilitate world economic stability and progress and the orderly functioning of the international monetary system. Furthermore, the risk that Arab states might obtain control over important sectors of the economies of individual industrial countries might be reduced if the Arabs could be persuaded to use the Agency as a major channel for placing their funds.



Possible Disadvantages of a Multilateral Agency

There are, however, possible disadvantages in the establishment of such an agency, depending on the terms which might be demanded by the potential lenders. If the Arab states should insist upon a guarantee of the value of their investment in terms of the purchasing power of industrial goods as well as an assured market rate or near market rate of interest, there might be serious questions as to whether such an agency would be in the best economic interest of the oil-consuming states.

Furthermore, if the Arab states should insist on a high degree of control over the placement of funds by the agency, its creation might merely increase the leverage of the oil-producing states by facilitating concerted action among them with respect to the manipulation of their funds.

Possible Types of Institutional Arrangements

There are, of course, many ways in which an investment agency could be organized. An agency designed to lend only or primarily to governments might have a structure similar in many respects to the IMF. If it were to emphasize development lending, the existing development institutions could serve as a model. If intended to invest primarily in marketable securities, however, a somewhat different



organizational structure might be required. This memorandum focuses on this latter type of institution.

The critical questions center around (a) the terms and conditions on which the governments of oil-producing states would make funds available and (b) control of investment policies and operations.

An agency whose primary function was to facilitate the placement of surplus revenues in marketable securities and property might be established through agreement among governments. It would need to be made clear that the agency was not expected to make investments on concessional terms. It could not be both an aid agency and an investment fund.

Membership. The members or "owners" of the agency would be governments of participating states. There would be two types or classes of members:

- Class A - those which expected to place funds for investment
- Class B - those in whose territories the funds would be invested.

Several questions arise:

- should any government willing to place funds with the agency be invited to become a member, or should Class A membership be limited to those few oil-producing countries expected to have large financial surpluses?



-should any government willing to allow the agency to invest in its territory be invited to become a member, or should Class B membership be limited to states with well developed capital markets which are receptive to large-scale investment?

Operational efficiency suggests that only countries supplying a significant amount of funds should be included in the first category and only those likely to be recipients of a substantial volume of capital should be included in the second.

Membership would involve specific obligations, particularly for the Class B members who might be required to (a) underwrite the liabilities of the agency through government guarantees and (b) with specific exceptions, provide "national treatment" for the investments of the agency.

Capital supplying countries would have to have some confidence that the agency would provide a better combination of safety and yield than unilaterally managed funds. One possible means of fostering such confidence might be to require the capital recipient countries to subscribe at least a token amount of capital for investment, thereby giving them some financial interest in maximizing the profitability of the investments made by the agency.

Participation Shares. In the case of oil-producing countries, participation shares could be allocated in proportion to the amount of capital subscribed. For capital recipient countries,



shares might be allocated on the basis of the relative size of the guarantees provided.

A country might be allocated both Class A and Class B shares. That is, an oil exporting country interested in having the agency make investments in its own territory might be allocated some Class B shares as well as Class A shares. Class B countries might be allocated Class A shares in relation to any token capital subscriptions.

The size of capital subscriptions and the size of the guarantees would have to be negotiated. Oil-producing countries might be urged to subscribe as much capital as they wished, although it would seem desirable to avoid a situation in which one single country (i.e. Saudi Arabia) had majority control of the entire agency.

One possible basis for allocating the shares of capital recipient countries might be the relative size of their capital markets, subject to some negotiated limit on the shares of any one country (i.e. the United States).

As a means of stressing the security of funds placed with the agency, it might be necessary to provide initial guarantees covering somewhat more than 100 percent of the amount of the original capital subscriptions of the producers.



Since the oil producing states may continue to have surplus income for a number of years, the agency would need to be designed so as to induce continuing contributions of funds. It would be important, therefore, to provide for regular or periodic additions to the capital subscriptions. This would no doubt require increases in the guarantees supplied by the Class B members, although it might not be necessary to maintain 100 percent coverages.

Control

In devising a management structure the task would be to meet the minimum demands of the capital supplying countries for control while giving the capital recipient countries as much of a voice as possible in guiding the flow of funds to those countries in need of capital.

It would have to be assumed that the producer countries would insist upon a majority interest. Conceivably, it could be agreed that producer countries would be allocated 60 percent of the shares and consumer countries 40 percent, although this would have to be negotiated.

It might be possible to develop a kind of bi-cameral board or at least a dual voting system to run the agency.

Overall policies presumably would be set by a Board of Governors representing all of the member states. It might be possible to achieve an agreement that adoption of



such policies would require not only a majority vote of all shares, but also minimum percentage of the shares of each voting class, counted separately. If this percentage were set at 40, for instance, a group of countries holding 60 percent of the votes of consumer countries could exercise a veto and a group holding 60 percent of the votes of the producer countries could exercise a veto. In this way it might be possible to protect the basic interests of each group.

Included among the policies to be determined by the Board of Governors might be such matters as the amount of additional subscriptions and guarantees to be called, the terms and conditions on which the agency would accept debt funds for investment, and the amount of such funds and the objectives of the agency in placing its funds.

It might prove possible to convince producer states that specific investment strategies and guidelines would be of primary interest to the oil consuming countries. They might be willing to allow these "Class B" members to develop strategies and guidelines subject to a veto by a two-thirds or three-quarters vote of the "Class A" (producer) countries. It would be necessary to have provisions which gave the producer countries reasonable assurance that its funds were being invested wisely, and in

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a sincere effort to maximize profits.

Method of Operation. Presumably, the actual investment operations would be conducted by a Fund Manager selected by the Board of Governors and acceptable to both classes of members. The Fund Manager would, of course, be assisted by a staff of expert investment advisors and authorized to employ consultants and agents to assist in handling confidential transactions. Borrowing a leaf from the practice of private funds, it might be advisable to provide financial bonuses to the managers of the fund in relation to its performance.

Investment operations might need to be divided into various categories. Equity holdings raise special problems to the extent they carry voting rights. Policies concerning the exercise of these voting rights would have to be established and precautions might need to be taken against an effort to utilize the holdings of the agency to influence the policies of private corporations for non-economic reasons (e.g., to boycott Israel or modify racial policies in South Africa).

In some cases the agency might decide not to take an active part in the management of a company in which it held stock, either refraining from voting its stock or supporting



the existing management. Direct investment would, however, probably have to be permitted. Given the volume of funds which could be made available and the sensitivity of many nations to foreign control, this question of "take over" could assume very great significance. The basic agency agreement might have to place specific limitations on the proportion of the equity in any one company which could be acquired without the consent of the government of that country, although some understanding should be reached which would ensure consent in all but highly sensitive cases. Except for this limitation, however, the agency probably should be treated as though it were a domestic resident insofar as investments in the territory of each member are concerned. No doubt the agency would have to be subject to the anti-trust laws of individual member states.

Tax treatment of income from agency instruments would be an important consideration. Exemption from all taxation would provide an unfair advantage to agency investments. On the other hand, the evasion of taxation on investments placed through private channels may be so large that the agency could not compete for Arab producer funds without some tax concessions. Thus a modest withholding tax might need to be negotiated.



Income from investment of capital subscriptions could be treated as equity income and distributed to member states in proportion to their contributions. If necessary, the agreement could provide that only Class A members would vote on the retention or distribution of earnings. Guarantees supplied by Class B members would probably have to be applicable both to capital subscriptions and to reinvested income.

Subscriptions of original capital would not be subject to withdrawal except through withdrawal from the agency. Additional capital subscriptions could be voted by two-thirds or three-quarters majority vote of Class A members.

Oil-producing states could also be invited to place additional funds with the agency for specific periods of time. Funds provided on this basis would presumably be in the nature of debt capital rather than equity and would earn a specified rate of interest rather than a share in the agency's earnings. The Board of Governors would be empowered to set the terms on which borrowing would be accepted, subject to majority vote of both classes of members, voting separately. The debt obligations incurred by the agency would have to be serviced prior to the distribution of dividends. The guarantees provided by Class B members could be called upon as necessary to repay the principal of debt obligations but not interest.

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In providing assurances needed to attract producing states as lenders, it might be necessary to offer some type of guarantees against loss of value through changes in relative exchange rates. This objective might be achieved by denominating all assets and liabilities in SDR while authorizing transactions to take place in any currency determined to be convertible into the currency of any other member. If the producer states, some of which are not currently participants in the SDR scheme, were unwilling to accept denomination of their claims in SDR, it might be possible to negotiate denomination in a basket of the currencies of Class B members. In any event, an effort could be made to meet the producer states' desires for guarantees by some such technique.

If the producer states were to insist on a purchasing power guarantee - that is, the write up in the currency value of their assets over time to reflect increases in the prices of industrial goods, consumer countries might want to reassess the desirability of creating such an institution. A purchasing power guarantee would be particularly inappropriate if a sizeable percentage of the agency's assets were invested in real estate, direct investment and other equities which could rise in value as inflation occurred.



Withdrawal of Equity Capital and Liquidation. The agreement would have to contain provisions for withdrawal of funds by a particular country for withdrawal from memberships and for complete liquidation of the agency. This could prove troublesome if the agency had, during the period of operation, acquired substantial direct investments and important holdings in other firms.

In the event one country should wish to withdraw part or all of its capital subscriptions, other Class A members might be invited to purchase its shares. Should this not be feasible the agency might be authorized to buy them back, presumably at asset value. The withdrawing country could be offered either specific assets from the agency's portfolio or payment in a member currency. Should the entire agency be liquidated it would probably be necessary to negotiate sales from the portfolio over a considerable period of time unless the Class A member states were prepared to take the agency's assets in payment.

Reports and Audits. The agency would have to provide periodic reports on its holdings - composition, transactions, profits and losses - to both classes of members. Records should be subject to frequent audit by a team of auditors, some chosen by the Class A countries and others by the



Class B countries. Members of the audit team should be in a position to file minority reports if they so desired. In this way perhaps both producer countries and recipient countries might be reassured as to the propriety of the agency's actions.



OFFICE OF THE SPECIAL REPRESENTATIVE
FOR TRADE NEGOTIATIONS

EXECUTIVE OFFICE OF THE PRESIDENT
WASHINGTON
20506

January 18, 1974

M- Trade-related Issues for Possible
Discussion at the February 11 Energy Conference

A number of trade-related issues have been brought sharply into focus as a result of current and anticipated actions on the trade side stemming from the short supply situation in oil. It is important that several principles be discussed which could serve as guidelines for acceptable national practices.

1. No country should take unilateral trade or monetary actions to improve or relieve its short term energy-related current account balance of payments position.

Discussion: It can be anticipated that governments could attempt to relieve adverse balance of payments pressures by (1) currency devaluations, (2) increased export subsidies, and/or (3) increased import restrictions. Inevitably such actions would engender counter-measures leading to still greater turmoil in world economic relations. If such measures are seen as necessary for other reasons, there should be prior consultations and discussions. The above principle should be firmly established in the IMF with discussion by the Group of 5 or the Committee of 20. Furthermore, it might also be useful to discuss it in the OECD, in conjunction with Working Party 3. It will also need to be recognized that trade measures falling within the purview of the GATT would be considered in that forum on the basis of established procedures.

2. Nations need to develop procedures for cooperative international management of short supply problems for a range of products.

Discussion: In anticipation of further potentially disruptive short supply situations, it would be useful to develop international consultative frameworks in which such problems could be addressed and guiding principles established. Only through joint management can the adverse economic impacts be



minimized. This matter could be pursued in the OECD framework, or on an ad hoc basis. It will also be desirable to examine the long-term implications of these issues, some general principles, and perhaps more permanent procedures in the context of the multilateral trade negotiations.

3. Bilateral agreements concerning products in short supply should be compatible with an internationally agreed framework.

Discussion: There will be a temptation for nations to engage bilaterally in barter arrangements or similar agreements which could tie up internationally traded commodities to the exclusion of other interested parties. This could lead to destructive competition, higher rates of inflation, and an unfortunate compartmentalization of the global trading system. The OECD might usefully pursue this issue, recognizing that it is a developed world problem, and an appropriate protocol could be worked out either in the OECD or in the GATT.



1g ✓
Draft: J. Fall
1/18/74N. Arab Investment in the United States

The following memorandum is a preliminary discussion of considerations which might be borne in mind regarding Arab investment in the United States.

Introduction

Public sources now estimate that total oil revenues for the 18 Arab countries, based on a combined output of 20 million barrels per day at an average price of \$11 per barrel for Libya and \$7 for the others, would reach \$60 billion dollars in 1974, up from \$6 billion in '71. (U.S. government estimates for non-Arab states may reach as high as \$22 billion.)

Given this enormous increase by the Arab nations and the presumption that there are limitations on the extent to which such revenues can be invested for purposes of Arab industrialization, military weapons systems or external development assistance programs, it has been assumed that a substantial portion of these revenues would flow to the United States directly or indirectly in the form of direct or portfolio investments.

Background

It should be recognized that there are certain very basic differences in the various oil producing nations -- some Arab, others non-Arab. All these producers, with divergent histories and political loyalties, have some significance to the U.S. in view of their growing oil revenues. For example, Indonesia, Venezuela, Iran and Nigeria can be expected to preserve considerable independence in the manner in which they deploy their oil revenues abroad. They can be expected to favor for the most part, Western economies. Iraq, on the other hand, given its ties with Eastern Europe can not be similarly predictable since she also maintains close relations with France.

At the present time Kuwait and Saudi Arabia are the only Arab states with substantial excess foreign currency holdings. These two nations, however, themselves have unique features which could alleviate fears that they might invest in unison in a way detrimental to the U.S. economy. Saudi Arabia is more conservative, religiously oriented and,



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except for the royal family, has little private capital. Kuwait, though, has a considerable pool of private capital.

Status of Current Investments

While it is extremely difficult under current data-gathering procedures to fully record Arab private or government investments, certain estimates and indications of trends are available. Total Saudi Arabian, Kuwaiti and Libyan government investments in U.S. government securities, bank deposits, equity and real estate are estimated to be approximately \$1 billion. Most Saudi royal family investments in the U.S. are thought to be in government securities. Kuwaiti private investments are less conservatively directed as evident in Kuwaiti interests in real estate in Minneapolis, Miami, Houston Atlanta, Sea Island (Georgia) and cattle feeding operations in Idaho. There are also reports that Iran is interested in purchasing certain U.S. firms for the specific purpose of transferring all or part of the facilities to Iran so as to provide the country with domestically based, defense oriented production capabilities. Apparently, export potential and in-country industrialization are important secondary considerations.

There is no evidence that Arab investors are poised for a major direct investment "invasion" of U.S. industry. There are, in fact, a number of reasons why the Arabs may hesitate to make massive direct investments in the U.S., foremost of which is a fear that the U.S. could freeze their assets. In an effort to reduce the impact or the effectiveness of such a freeze Arab investors may strive for a broad diversification of their investments so as to avoid presenting a large target to which internal political pressure could gravitate. For these reasons also we may witness a greater tendency toward portfolio than toward direct investments. In either case, given the strength of the dollar and the relative size of the U.S. economy, most notably our highly developed and open capital market, we should be the recipient of considerable Arab investment flows.

Safeguards

The United States maintains certain restrictions on investment by foreigners in specific sectors of the economy. These restrictions, frequently associated with national security reasons, vary from total exclusion to limits on maximum foreign participation. These restrictions



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or prohibitions include: 1) domestic communications; 2) domestic air transport; 3) hydro-electric power production and utilization or production of atomic energy; 4) coastal and fresh water shipping; and 5) Federal mining claims and Federal oil or mineral leases.

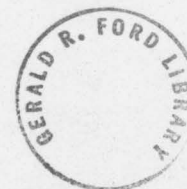
Additional U.S. protection against any abuses by foreign investors, whether private or governmental, are found in SEC regulations which require full financial and intent disclosures in takeover bids. Protection against monopolistic and anti-competitive practices are afforded through the anti-trust laws.

Various individual states also maintain restrictions on foreign ownership of property, particularly agricultural land. In the event Arab investments are directed in considerable volumes to real estate it can be expected that certain states will promulgate review and reporting procedures for the express purpose of excluding such investments.

The establishment and ownership of financial institutions by foreigners are subject to several types of limitation. At the Federal level, only banks incorporated within the United States are permitted to become members of the Federal Reserve System. A number of states have restrictive legislation against foreign or foreign-owned banks operating in the state.

The Federal government also has a variety of review procedures regarding the transfer of technology associated with national defense which could possibly be tightly administered to discourage Arab investments in industries determined to be critical to the economy and at the same time not appear to be overly discriminatory.

The ultimate protection against actual abuses to the U.S. economy by Arab investment resides in the location of the investment within the territorial and legal jurisdiction of the U.S. It appears that under most circumstances, Congressional authorization would be required for the U.S. to seize and expropriate such investment. Consideration should be given to determine whether such seizure could be accomplished under existing legislation. We can assume, however, that in an emergency or in response to unusual circumstances the appropriate statute would be quickly forthcoming from the Congress.



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November 29, 1973

Question: What are your expectations about the volume of investment in the United States by the Arab oil producers? What inducements do you expect the U.S. will offer to attract these investments?

Answer: We foresee that the receipts of the Arab oil-producing nations from petroleum exports will very substantially exceed their likely expenditures for imports of goods and services. Except to the extent they choose to use their funds for aid to other Arab states or to developing nations, the bulk of this surplus of receipts will, almost inevitably, be invested initially in the industrialized world. It is my general assumption that, given the relative size and dynamic role of the U.S. in the developed world economy, this country will directly and indirectly be the recipient of considerable Arab investment flows.

The large, highly developed, and open capital market of the United States is a natural outlet for Arab countries that have a need to invest profitably substantial amounts of funds. Such investments might be placed directly or through portfolio managers in Switzerland and other countries whereby the identity of the owners might be cloaked. Furthermore, our productive and diversified economy is also in an excellent position to attract resources that the Arab oil countries may wish to place in the form of direct investment, such as in downstream energy facilities and in the acquisition of ownership shares in petroleum-producing companies.

It is also assumed that a significant portion of increased Arab investments will be channeled to the Euro-markets. Such investments, as well as Arab investments in third country markets, can also have a positive effect on the United States balance-of-payments position. Some of these investments can be expected to be re-invested in the U.S. by Euro-market intermediaries or agents. More indirectly they should also tend to expand lendable resources in Europe or elsewhere for projects in the developing nations which might otherwise be financed in our market.

Experience to date suggests that Arab funds invested mainly in Europe.



As implied in the foregoing, an increased flow of Arab investments to the U.S. should develop as a natural consequence of market forces. I do not believe that it is either necessary or desirable for the U.S. Government to offer special inducements or incentives designed specifically to attract Arab investments to this country. We are, however, continuing to review U.S. policies and regulations, such as the withholding tax, that may act as deterrents to foreign investment. In this connection we believe that the forthcoming removal of controls on the outflow of capital from the U.S. will be beneficial in enhancing the psychological security of foreigners investing in the U.S. Finally, it should be noted that the Committee of Twenty in formulating improvements in the international monetary system is discussing adaptations needed to accommodate the special situation created by the growing investments of the oil-producing nations.



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