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Trade?

Prime Minister Trade

A note on re-cycling schemes currently under discussion.

MAP 12/8.

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PRIME MINISTER

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OPEC SURPLUSES

When we considered the Secretary of State for Trade's paper on trade policy (E(80)43) at E on 25 June, it was suggested that the less developed countries could buy more of our exports if their balance of payments problems were eased by encouraging greater flows from oil surplus countries. I promised to produce a note about the various ideas now current for recycling the OPEC surpluses.

2. Before considering them it is useful to distinguish between improving the recycling of oil surplus producers' money on non-concessional terms, and inducing them to put up more aid. The latter is important to the poorer developing countries (many of them in the Commonwealth) which do not have the same capacity for adjustment as those further along the road, but we cannot hope that this will be large enough to reduce substantially the recycling problem. The main problem is to devise new methods of channelling the surpluses which would be acceptable to the oil producers.

3. The ideas for recycling the OPEC surpluses are aimed at mitigating the immediate balance-of-payments problems of the LDC's, and at creating the conditions for recovery and renewed long term growth. They may not even maintain, still less increase in the long run, these countries' imports from us or from anyone else. But they are a first necessary step towards more trade in the future.

4. The attached note has been prepared by officials of the Treasury, in consultation with the FCO, the Bank of England and the Departments of Industry, Trade and Energy. It explains the background, and sets out the various ideas now circulating, in international organisations and here in London. Little of this is new, but colleagues may find it helpful to have this summary. No new decisions are needed at present. I do not think we need meet to discuss the paper. I shall assume, unless colleagues indicate otherwise, that this analysis is generally acceptable. Officials will proceed on the lines set out in this note, and will react to the various current proposals on the basis set out there. In addition, they will float the new UK proposals described at the end of the paper, whenever opportunity arises. I should however emphasise that none of these are particularly new or fundamental. They will supplement and not replace the other schemes being considered. Because they are designed to minimise the burden on the UK and other 'developed' economies, they will not be particularly welcome either to OPEC or to the LDCs. They are mainly intended to show that we are doing our bit in the general study of the problem.

5. I am sending copies of this minute to the other members of E Committee, and to Sir Robert Armstrong.

(G.H.)

11 August 1980

ECYCLING THE OPEC SURPLUSES

Background

The 1979-80 round of price increases has hit the LDCs badly. Some have suffered much more than others. But nearly all have balance of payments problems. The steady progress of the 60s and early 70s has slowed down and threatens to decelerate further. The LDCs as a group recovered fairly well from the 1973-74 oil shock. But the overall picture masks wide disparities of economic growth between countries within the group; some of them have borrowed extensively. This adds to the problems of facing another sharp increase in their oil import bill, (the working assumption by the World Bank, which may even turn out to be on the low side, is that oil prices will increase by 3% per annum in real terms in the 1980s), yet oil is essential to keep their economies going. Those who depend on imported food cannot cut their import bills too far. If they reduce their imports of manufactures, they hurt the industrialised countries and their own industrial development. Many of them lack the resources to increase their exports quickly and may face increasing protectionist pressures. The industrialised countries, to whom they look to for markets, are mostly in recession and are determined not to spend their way out again, for fear of inflation. The conditions which create the need for more help - large payments deficits, high inflation and weak activity following the rise in oil prices also make it difficult for Governments to maintain aid budgets. The LDCs which buy most from the industrialised countries are the fastest growing, relatively well-off ones like Brazil and Korea which rely heavily on private capital markets, whereas official aid goes mainly to the poorest LDCs. So the amount of direct additional help industrialised governments can give, either by way of trade or aid is likely to be limited.

2. In any case, aid, although important for the poorer countries is historically a small part of the total flow of funds to the LDCs as the chart at Annex A shows. The greatest part comes from their export earnings ($244.4 bn in 1979). Private direct and portfolio investment, bank loans and export credits provide the next slice ($43.17 bn). In 1979, only $22.27 bn came in the form of bilateral and multilateral

aid from DAC members. Oil surplus countries provided another $4.7b. Private flows will continue at a high level. But investment is limited to some extent by lack of profitable outlets in the LDCs. The banks are not short of funds, since they take in surplus oil money on a large and increasing scale. But they are becoming reluctant to increase their exposure in some of the riskier LDC markets. The international Task Force on Non-Concessional Flows (reporting to the joint Development Committee of the IMF and IBRD) believes that the banking system will be able to carry the main burden of recycling through the rest of 1980, but the process could become increasingly difficult thereafter.

3. This is where the surplus oil producers come in. Their money is needed for balance of payments, for direct investment and aid to the poorer LDCs. So far a great deal of their surpluses has been placed short term, notably in bank deposits. The problem is how to persuade them to lend for longer periods either directly or through the international financial institutions and to accept more of the sovereign risk on commercial lending. The industrialised countries will take every opportunity of pressing this case, particularly in the forthcoming Global Negotiations. However, this will not be easy since the surplus oil producers argue - and believe - that they are already accepting their fair share of risk by converting a scarce resource - oil - into financial assets which tend to decline in value.

4. The rest of this paper is about various current schemes for facilitating these flows. Some are already on the agenda of the IMF and the IBRD. Some are new proposals, deriving from the Brandt and other recent reports. Many of them involve a risk to the industrialised countries which would be required to underwrite LDC borrowing and relieve surplus oil producer lenders of costs or risks which, in principle, we believe they should bear themselves. But some bargain may be needed to persuade surplus oil producers to lend or to soften their terms of lending. The present UK attitude to each of these schemes is described. The note ends with three possible new proposals (none especially exciting) which the UK might put forward as a contribution to the debate; all are designed to tap OPEC funds in various ways without increasing the burden on the industrialised countries.

A. Work in hand

(i) IMF

5. At the meeting of the Interim Committee in April, it was agreed that the IMF should "play a growing role in the adjustment and financing of these (balance of payments) imbalances". A two-pronged proposal has been under discussion:-

(a) that the Fund should be prepared to lend larger amounts, over a longer period;

(b) that the Fund should augment its resources, in addition to the Seventh Quota Review, by borrowing from surplus countries.

6. The UK has argued that while more time for adjustment to external deficits should be allowed, Fund resources will have to remain subject to some appropriate conditionality and be provided in conjunction with programmes aimed at restoring a viable balance of payments position. The fact that the deficit may be external in origin, eg the higher oil prices, does not diminish the need for corrective measures, if the external factor is expected to persist. The Fund reviewed its conditionality in 1979 and issued some more flexible guidelines. These would still hold good though there will be relaxation in the sense of offering a longer time horizon for adjustment in some cases. The unconditional resources available from the Fund should not at present be changed save that they will expand pari passu with the 50% increase in all quotas now in process of enactment. However, there may be some scope in the future for re-examining the balance between Fund resources with high conditionality and those with relatively less (eg first credit tranche, CFF etc).

7. On (a) above, the Fund has proposed allowing countries to borrow up to 600% of quota (the maximum hitherto has been about 450%) and allowing countries to draw this in three annual tranches. In exceptional circumstances even this limit might be exceeded. Though the details remain to be settled, the UK and a number of other countries have generally welcomed the proposal.

8. On (b), the Fund Staff think the existing resources available to the Fund, which consist of the currency supplied when countries pay in their quotas, and the Supplementary Financing Facility (SFF), which is a line of credit provided by surplus countries (industrial and OPEC members) will suffice until early 1981 by which time the SFF will be fully committed. However, a further $7-8 billion might be required in 1981-83 given the enlarged access to quotas, and discussions with potential lenders within OPEC have begun. Until recently, surplus oil producers have been interested in lending to the Fund, but not on concessional terms. (There is now a political difficulty - see paragraph 14 below.)

9. Other difficulties have arisen in these discussions. In the past, schemes whereby countries provided the Fund with additional resources, eg the General Arrangements to Borrow (GAB) within and for the Group of 10 industrial countries and the SFF, have taken the form of lines of credit. The Fund has drawn on these resources as required and when repayments have been made the money has passed straight back to the lenders. This is convenient to the borrowers but leaves the lenders with a commitment to provide or take money at short notice.

10. In discussions with the Fund Staff, the Saudi Monetary Authority (SAMA) have argued that they should provide the Fund with money and receive repayments on a fixed schedule. If the borrower continues to enjoy flexibility, the Fund will experience periods when it has either a surplus or deficit of currency. If for example the Saudis had deposited dollars before they were on-lent, the countries with a net creditor position (the UK is likely to become a net creditor fairly soon) might be asked to hold more dollars in their reserves which would reduce their SDR-denominated claims on the Fund. In this way they would incur the exchange risks and the inconvenience of managing short term funds which the OPEC countries are seeking to avoid.

11. We are urging the Fund Staff to look for ways round this problem which avoid giving in to this demand. One group of Fund creditors should not be asked to help out another group. This would be a major departure from the Fund's practice of even-handedness among all members.

...

The exchange risk and the problem of short term fund management should remain the responsibility of the oil surplus countries lending to the Fund. In the case of the UK there would almost certainly be legislative and accounting obstacles to manipulating the exchange equalisation account in this way, even if the resultant change in the composition of our reserves were not necessarily very costly.

12. There are possible ways round the problem. The Fund could invest in SDRs to match its SDR liability to OPEC countries; it could bear the risk itself but minimising it by investing in a spread of currencies (though any risk to the Fund's financial position could have implications for all members, perhaps even an increase in its charges at some stage); it could try to negotiate a shorter period of notice for drawing on the oil surplus countries or restrict borrowers flexibility in drawing or repaying funds. The ideal, however, would be to get the oil surplus countries to accept the line of credit arrangements.

13. At a technical level, while the prospects for borrowing large sums directly from oil surplus countries remain good, the latter will try to drive a hard bargain. There is little prospect of the money being concessional. The oil producers will try to shift as much of the exchange risk and portfolio management onto the Fund or the other creditors as it can. There are signs that some oil surplus countries will be prepared to contribute to subsidies of the Fund's more expensive facilities but they may insist on a contribution from the industrialised countries.

14. However, at the political level a threatening cloud has appeared over this issue. As a result of opposition by the developed countries to the admission of the PLO as observers to the Bank/Fund Annual Meeting, the Saudis and others have said that they are not "at present" willing to consider lending to the Fund and have taken similar action in the Bank. This will be a troublesome issue, as the the US are equally adamant that admission of the PLO would put at risk Congressional approval of the IDA replenishment. Meanwhile the Fund Staff are looking into the prospects for borrowing from the international capital markets, which would tap OPEC surpluses, at least in part, by a more indirect route.

15. Although not originally conceived as a recycling measure, the proposal, espoused by Brandt, to alter the allocation of SDRs in favour of LDCs by skewing the allocation of SDRs in favour of LDCs is being re-examined by the IMF. Though it has a number of attractions, in particular it could provide LDCs with non-borrowed reserves and reduce their resources to credit markets, and in one form would have no public expenditure cost, it also raises a number of difficulties. Would the link detract from the quality of the SDR as a reserve asset? Would such allocations be inflationary? Officials are still considering the issues.

(ii) World Bank

16. The World Bank group of institutions provides three main kinds of development finance. The IBRD itself lends on long but non-concessionary terms ($8.6 bn this FY); the International Development Association (IDA) on very soft terms ($3.6 bn this FY if its last replenishment comes into effect); and the International Finance Corporation (IFC) invests in equities in partnership with private capital ($571m this FY). The IBRD and IDA lend chiefly for projects, but have also done a relatively small amount of more general "programme" lending. This is now to be boosted by a system of "structural adjustment loans", designed to encourage LDCs in programmes of investment which would adjust their economies in the medium term to high oil prices. We support this scheme so long as it does not encroach on IMF operations, and several loans have already been made. But the money has to come out of existing lending programmes - it is not additional. So the question is whether it could be matched with extra OPEC money under some form of co-financing. The main current proposals for augmenting World Bank flows are:-

(a) The General Capital Increase (GCI)

All members are committed in principle to a doubling (an increase of $40 billion) of the Bank's capital. The paid-in portion of subscriptions will be called up by instalments over five years starting in September 1981. OPEC members can subscribe up to about $3.4 bn of which about $260m will be paid-in. Some increase in a few OPEC countries' share-

holdings through selective capital measures is hoped for eventually, but the scope for this in the absence of IMF quota increases is limited. The necessary legislation to enable the US to participate in the GCI has yet to be introduced in Congress, where the sixth replenishment of IDA (see sub-paragraph f below) is running into more opposition than usual from the anti-aid lobby. The UK has consistently supported the GCI, but no decision has yet been made on the size and timing of the UK subscription.

(b) Increasing the gearing ratio

The Bank's total lending is limited to the total of its subscribed capital and its reserves. This cautious 1:1 ratio is laid down in its Articles. The Bank has long been firmly established and it may now be possible to increase this ratio. The Brandt report strongly recommends this and such a change would allow the Bank to increase its direct borrowing from all sources including the oil surplus producers. In addition to certain political difficulties inherent in amending the Articles, such a change would require careful handling if it were not to imperil the Bank's triple A rating in New York markets, and drive up the cost of its borrowing. The GCI will greatly increase the annual value of IBRD borrowing and it is possible that a dilution of the ratio which constitutes a 100% guarantee to lenders could prejudice its ability to fund itself in the future. The UK might wish to support this proposal but would want a reasonable assurance the change would not damage the Bank's standing. We are not anxious to press forward immediately in case the US Congress sees it as a soft option to the GCI, which in our view should come first. The IBRD management appear to share this view. It will consequently be some time (perhaps 2 years or more) before a change in the gearing ratio could be seriously considered.

(c) Increase in callable capital

Member governments' subscriptions which form the Bank's capital base, are in two parts, a paid-in portion and the

remainder "on call". At the Bank's inauguration the paid-in portion was 20%. In 1960 the Bank's subscribed capital was doubled, but the portion due to be paid-in has never been called. Thus an alternative to a further GCI with a paid-in element or to a change in the gearing ratio would be a general increase in callable capital. This would continue 100% backing for the Bank's obligations, while adding to governments' contingent liabilities. Provided the Bank continued to follow prudent policies, the likelihood of the callable capital being called would remain remote. If the present GCI collapsed because of Congressional or other difficulties, this might be a focus for discussion.

(d) New Energy Affiliate

The IBRD were asked to examine this possibility by the Venice communique, and will produce proposals in the autumn. The idea of a separate institution has been promoted both by the US and by France (the latter, however, wants one outside the World Bank): but while we have supported this study, we should be hard put to it to find any subscription to a new body from the Aid Programme. Much depends on whether any new affiliate were to be limited by the Bank's existing lending/capital ratio. If it were, any possible additionality would be limited to any co-financing it was able to attract. The Bank believes there is no shortage of sound energy projects, even outside the politically-safe markets where the international oil companies could fund the more attractive projects without its participation.

(e) Co-financing

This is a device by which the IBRD shares part of the cost of a project, either with official aid agencies or with private banking sources. The volume of such co-financing has diminished in the last couple of years, but the IBRD staff is now anxious to increase it again. The UK supports such moves, but we have a modification and extension of our own to propose (see paragraph Ci below).

(f) IDA6

The sixth replenishment of the International Development Association was due to be ratified by 30 June last but as in past replenishments it has run into difficulties in the US Congress which has not yet authorised US participation. Without the US the replenishment cannot take place. IBRD management is therefore seeking a "bridging operation" by which the major subscribers, including it is hoped, some OPEC countries, would provide, in advance, the first tranche of their contributions to IDA6, until the US is in a position to pay up. The amount of OPEC money involved is small (although some OPEC members will contribute in percentage terms more than their current share in the Bank's capital). If IDA6 fell through and individual members did not increase other aid flows by the amount of their agreed subscriptions to IDA, there would be a further shortfall over the next ten years of $12 billion in the flow of funds to LDCs. The UK is presently committed to supporting IDA6, but possible UK participation in a bridging operation remains to be decided.

(g) At the behest of the Task Force on Non-Concessional Flows, the World Bank Staff are studying a proposal for a new bank affiliate, capitalised out of earnings, which could tap the euro-markets rather like a commercial bank. This idea is at a very preliminary stage, but by avoiding some of the difficulties of the traditional gearing ratio might be able to mobilise additional capital at virtually no cost to IBRD members. If the staff study shows the idea to be technically feasible, it could be promising.

B. Recent new proposals

17. A great deal of ingenuity is being applied to devising schemes which would increase the flow of non-concessional funds from OPEC to the LDCs and ease the strain on the international banks and capital markets. Subsequent paragraphs review some of these proposals, setting out the pros and cons of each and suggesting the attitude UK

representatives should take in the various fora in which they are raised.

(a) Arndt

18. The Report by a Commonwealth Group of Experts under the Chairmanship of Professor Arndt covers much the same ground as the Brandt Commission. It has proposed adapting existing mechanisms for reserve diversification by surplus countries to achieve recycling. Briefly the scheme would work as follows. SAMA would deposit dollars with the Bundesbank, Bank of Japan (or even the Bank of England) and receive DM, yen, sterling securities, these transactions being conducted off market. The Bundesbank etc would deposit the dollars with the US Treasury in exchange for Treasury notes; the US Treasury would lend the dollars to the IMF in exchange for SDR denominated IMF liabilities and the IMF would lend the dollars to LDCs. The advantage claimed for the scheme is that it would build on existing mechanisms - the Saudis have already acquired DM and yen securities and the German and Japanese central banks already hold most of their dollars with the US Treasury. The innovation is the movement of dollars from the US to the IMF. The chart at Annex B summarises the flows.

19. The scheme has several drawbacks, apart from its evident complexity. First it requires Germany, for example, to issue DM liabilities to the Saudis not just to finance a current account deficit, as they are doing at present, but to acquire more dollars in its reserves. It is doubtful whether Germany would be so keen to allow the DM to develop as a reserve currency if it did not have a deficit to finance. Secondly the proposal whereby the Bundesbank would, to compensate it for the exchange risk, pay the Saudis slightly less than market rate of interest and receive from the US a rate slightly higher than the market rate, would be difficult to negotiate. Thirdly, the fact that the dollars taken initially from SAMA are ultimately reissued to LDCs could put downward pressure on the dollar.

20. Thus the scheme looks complex, difficult to negotiate and possibly technically unsound. Unless it could attract larger quantities of funds, it would seem to offer little advantage over putting oil surplus

money directly into the IMF. However some form of indirect recycling mechanism may need to be considered if oil surplus countries continue to not cooperate with the IFIs because of policy towards the PLO (see paragraph 14 above).

(b) Guarantees

21. The French representative on the Task Force on non-concessional flows has advocated more extensive use of guarantees. He has listed a number of variants. In one there could be an international loan insurance fund which would guarantee loans to developing countries. Banks could pay an insurance premium, as to ECGD, but governments would bear any residual loss. In another variant, put forward by Mexico, a fund could be established, which would raise money under its own name on international capital markets or from governments and lend to developing countries to buy capital goods. Governments who felt unable to subscribe to bonds issued by the fund might offer to guarantee loans.

22. The French have suggested their own variant involving partial guarantees (35-40 per cent) for credits to countries on the threshold of credit-worthiness and of access to private capital markets. The scheme would not apply to the poorest countries and those already enjoying access. The guarantees would apply to market borrowing bond issues and even direct OPEC loans but would exclude export credits. The burden would be shared by the industrialised countries, oil producers and perhaps even the borrowing governments. The first two groups would be guarantors pledging callable capital and the latter would pay a fee equal to the difference between the actual cost of the guaranteed loan and the notional cost of an unguaranteed loan.

23. The Arndt Report has suggested that its recycling scheme could be put on to a longer term footing by the establishment of a system of government guarantees. Using such guarantees, an institution would be able to raise funds for on-lending to LDCs. These funds could include the proceeds of the off market diversification arrangements described above (though if there are guarantees OPEC would probably be prepared to lend directly to the institution).

24. The World Bank and the Regional Banks have the power to issue guarantees but as they count against their capital in full, guarantees simply displace direct lending and therefore virtually none have been issued. The IMF has no power to offer guarantees under its Articles.

25. Part or full guarantees have the possible attraction of facilitating loans to LDCs now on the margin of, and relatively unknown to, the markets with no cost to public expenditure but there are several objections. Such a system might reduce the pressure on commercial lenders to exercise their judgement and relieve them of risks they should properly carry. It could undermine the independent credit-worthiness of LDCs still able to borrow commercially. It would not of itself lead to any certainty that the money borrowed would be usefully employed, (a necessary precondition for any charge on the UK aid programme), should the premia charged for what is basically a secondary banking service not be enough. Such lending might best be organised through a separate institution possibly linked to the World Bank, charging premia and scrutinising the uses to which funds were applied. If no new institution were set up, the Bank's Articles could be re-examined to make guarantees more attractive by altering present constraints, either separately from or in conjunction with a general change in the gearing ratio.

C. Possible UK Initiatives

26. (i) An OPEC/IBRD Joint Lending Programme. This proposal builds on the existing arrangements for co-financing (paragraph 16e above). The idea is to develop a formal 'umbrella' scheme, under which OPEC lenders, either individually or through some new collective institution, would provide perhaps half the capital for an IBRD loan directly at normal IBRD interest rates, leaving IBRD from its ordinary resources to put up the other half. No guarantees would be given to the OPEC lenders. The two matching loans would be linked by cross-default clauses, thus giving OPEC lenders the protection of ODC reluctance to default on IBRD loans. The lenders would also get the assurance of IBRD project appraisal, which many of them are not yet equipped to carry out. (The lenders

might however want, and could reasonably be given, a share in the process of selecting projects.) There are two main problems. The scheme would be more complex for IBRD to administer. More seriously, oil surplus countries normally prefer medium to short maturities, while IBRD lends for fifteen to twenty years. A formal scheme of this kind, with widely-known terms and standard conditions, well-publicised and with a degree of political commitment on both sides, might attract more funds than the present series of ad-hoc arrangements.

(ii) Factoring of IBRD loans. Oil surplus countries' preference for shorter maturities could be met, without disturbing IBRD's wish to lend long, by arranging to sell to them IBRD's rights under existing loans a few years before they fall due for repayment. This would release considerable funds for immediate new loans. Something of this kind has already been done in the past on a small scale and is being further studied by the Task Force on Non-Concessional Flows. It might be necessary for the Bank to underwrite the borrower's liabilities in some way, or to offer a discount, to make these rights sufficiently attractive. The main problem is however the effect on IBRD's loan position. An increase in immediate liquidity would be at the expense of greatly lengthening the average maturity of its loans since new lending involves grace periods. The likely effect of this proposal on the Bank's standing in the capital markets would have to be carefully assessed.

(iii) Use of Regional Development Banks (RDB's). There are four such autonomous banks and the UK is a non-regional member of three of them. The fourth (the African Development Bank) is currently restricted to regional members but arrangements are in hand to allow non-regionals who already contribute to the African Development Fund (which includes the UK) to join. Membership provides the eligibility for UK exporters to tender for projects funded by the banks. Except for OPEC

members within the particular region served by each bank, OPEC countries broadly do not support the RDB's. UK action to urge OPEC membership of the Banks or to encourage increased subscriptions is somewhat circumscribed, but we can discuss with other major aid donors, and with the managements of the Banks what might be done to bring about increased OPEC participation, which would generate additional funds from markets in excess of the sums actually paid-in by OPEC countries.

H M Treasury
7 August 1980