FEDERAL RESPONSE TO OPEC COUNTRY INVESTMENTS IN THE UNITED STATES (Part 1—Overview)

HEARINGS

BEFORE A

SUBCOMMITTEE OF THE COMMITTEE ON GOVERNMENT OPERATIONS HOUSE OF REPRESENTATIVES

NINETY-SEVENTH CONGRESS

FIRST SESSION

SEPTEMBER 22 AND 23, 1981

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FEDERAL RESPONSE TO OPEC COUNTRY INVESTMENTS IN THE UNITED STATES

(Part 1—Overview)

TUESDAY, SEPTEMBER 22, 1981

HOUSE OF REPRESENTATIVES,
COMMERCE, CONSUMER,
AND MONETARY AFFAIRS SUBCOMMITTEE
OF THE COMMITTEE ON GOVERNMENT OPERATIONS,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:05 a.m., in room 2247, Rayburn House Office Building, Hon. Benjamin S. Rosenthal (chairman of the subcommittee) presiding.

Present: Representatives Benjamin S. Rosenthal, Stephen L. Neal, Hal Daub, and John Hiler.

Also present: Representative Elliott H. Levitas.

Staff present: Peter S. Barash, staff director; Stephen R. McSpadden, counsel; Doris Faye Ballard, clerk, and Jack Shaw, minority professional staff, Committee on Government Operations.

OPENING STATEMENT OF CHAIRMAN ROSENTHAL

Mr. ROSENTHAL. Today and tomorrow, the Commerce, Consumer, and Monetary Affairs Subcommittee continues its oversight examination of the Federal response to foreign investment in the United States by focusing on OPEC country investments.

Since the subcommittee's last set of hearings into this subject 2 years ago, OPEC surplus funds available for investment have increased by $200 billion, according to U.S. Government estimates.

In a December 1979, report on OPEC investments, the General Accounting Office concluded that:

> * * * the existence of a clear and present danger is not the issue. Instead, we question the ability of the Executive Branch to detect such a threat in a timely manner, should it occur * * * U.S. officials might not be aware, on a timely basis, if particular strategic investments were made to influence policy.

GAO's recommendations to improve monitoring of OPEC investments—and recommendations made in a report by this subcommittee—have largely been rejected by the executive branch.

The adequacy of Federal efforts to monitor and evaluate OPEC investments is of particular importance for two reasons: First, because of the size of these investments—no Federal agency seems to know how large—and, second, because they are controlled by governments, rather than by private parties, they can be used for political reasons.

These hearings will examine, first, the effectiveness of current U.S. Government practices and procedures for monitoring OPEC and other country investments; second, the disposition and impact of OPEC surpluses in the United States and abroad; third, OPEC country-by-country investment strategies and trends; fourth, the treatment of OPEC investments by the U.S. Government, including promises of strict confidentiality and favorable tax treatment; and fifth, the stability of U.S. banks holding OPEC surpluses.

Specifically, we hope that our hearings will produce answers to the following questions:

Did the U.S. Government's monitoring system fail to identify $60 billion of capital inflows into the United States during 1979 and 1980; and did it accurately identify Iranian investment in the United States—both prior to and after the freeze?

Are OPEC country investment statistics, which are classified as "secret," and denied to senior Government officials, including Governors of the Federal Reserve, treated differently than investment data of other countries?

Does the U.S. Government understate OPEC ownership of U.S. real estate and business?

Have U.S. banks surpassed country exposure lending limits in recycling petrodollars to the Third World and, if so, with what potential consequences?

Are the salaries of certain employees of the U.S. Treasury Department paid by the Saudi Arabian Government and what is the purpose of large Saudi deposits with the U.S. Treasury?

And, has OPEC attempted to influence U.S. tax and other policies through their investments and, if so, with what result?

The Securities Industry Association submitted a statement to the subcommittee in which they critiqued Treasury's foreign portfolio investment data collection efforts. Without objection, that statement will be placed in the record.

[The prepared statement of the Securities Industry Association follows:]

STATEMENT OF THE

SECURITIES INDUSTRY ASSOCIATION

TO THE

SUBCOMMITTEE ON COMMERCE, CONSUMER

AND MONETARY AFFAIRS,

U.S. HOUSE OF REPRESENTATIVES

Introduction

The Securities Industry Association (SIA) appreciates the opportunity to participate in the committee's hearings on the adequacy of the Treasury Department's foreign portfolio investment data collection efforts.

SIA represents over 500 leading investment banking and brokerage firms headquartered throughout the United States which collectively account for approximately 90% of the securities transactions conducted in this country. The activities of SIA members include retail brokerage conducted on behalf of 30 million individual shareholders, institutional brokerage, over-the-counter market making, various exchange floor functions and underwriting and other investment banking activities conducted on behalf of corporations and governmental units at all levels.

SIA is well-acquainted with the collection of data on foreign portfolio flows and the Treasury's information on such flows. Since early 1978, SIA has published comprehensive analyses of foreign portfolio investment in U.S. securities markets, relating capital flows to currency fluctuations, stock market trends, general economic conditions and other relevant factors. SIA collects data compiled from S Forms received directly from 23 securities firms. Collectively, these firms account for about two-thirds of total transactions in U.S. corporate equities between U.S. and foreign residents reported to the Treasury.

Sources of Data

S Form

The Treasury Department, with the assistance of the Federal Reserve Bank of New York, collects data and publishes information monthly on international capital movements, comprised of the following categories: liabilities to foreigners reported by banks and security brokers and dealers in the U.S.; claims on foreigners reported by banks and security brokers and dealers in the U.S.; claims on and liabilities to unaffiliated foreigners reported by non-banking business enterprises in the U.S. (principally importers, exporters, industrial and commercial enterprises, and financial intermediaries other than banks and brokers); and, transactions in long-term securities between U.S. and foreign residents.

Information on transactions in long-term securities -- U.S. Treasury bonds and notes, Government agency issues, corporate bonds and corporate stocks -- is reported monthly on the Treasury's S Form, predominantly by banks, brokers and securities dealers. Other industries are required to file S Forms when purchasing or selling long-term securities directly to or from foreign investors as well. The data are reported to the Treasury on a country-by-country basis. Reporting firms record the dollar value of transactions executed on behalf of foreign investors in the appropriate country category. A breakdown of foreign portfolio investment by type of industry is not required.

Problems with the Data

Besides receiving copies of S Forms from 23 securities firms SIA obtains data on commissions generated through transactions executed on behalf of foreign customers. In the course of discussions with these 23 firms, SIA became aware of a number of shortcomings in the data received by the Treasury Department.

Perhaps the most serious shortcoming results from inconsistent categorization of transactions reported on the S Form. Most firms categorize transactions executed on behalf of foreign customers on the basis of customer residence. Several firms, however, categorize such transactions on the basis of which branch office overseas received the order. Therefore, it is difficult to receive an accurate picture of the origin of foreign portfolio funds, although measuring the aggregate amount of portfolio investments by foreigners is not affected.

Additionally, clerical errors are not infrequent. Employees who handle foreign business within the firms are not the same individuals responsible for recording transactions on the S Forms. Thus, there are several steps in the process of filling out the forms at which errors can occur. Clerical errors take one of several forms: the dollar value of a trade is inaccurately recorded; a transaction is recorded in the wrong country category; or, foreign direct investments -- defined as ownership of 10% or more of a company's outstanding stock -- are reported on the S Form, which should only include portfolio investments.

The Federal Reserve Bank of New York, with which the S Forms are initially filed, has difficulty in spotting unusual figures. SIA is sometimes able to identify clerical errors when transactions data are inconsistent with other information, such as commission data or currency fluctuations.

In addition to inaccuracies, we believe underreporting contributes to distortions in the Treasury's data on foreign portfolio investment in the U.S. as well. When the analysis of foreign capital flows was initially instituted by the NYSE, several securities firms were unaware of their responsibility to file the S Form. While most firms are now cognizant of this responsibility, it is likely that a number of securities firms and banks, whose foreign business comprises a smaller portion of their total business, do not file S Forms. We suspect that omissions on the part of non-financial concerns occur as well. While the Treasury does indicate that non-banking U.S. business enterprises engaged in financial transactions with foreign investors are required to file, such companies may be unaware of their responsibility.

In short, the Treasury's data on foreign portfolio flows are far from perfect. Inconsistencies in classifying information and clerical errors contribute to inaccuracies. Furthermore, insufficient awareness on the part of organizations regarding their responsibility to report the required information leads to underreporting.

Treasury's Benchmark Surveys

In addition to collecting data and publishing information on international capital movements, the Treasury Department has conducted comprehensive benchmark studies for year-end 1974 and 1978. Data for the 1978 survey were compiled from reports filed by: all non-bank U.S. issuers with assets over $50 million and all U.S. banking organizations with assets over $100 million; any non-bank issuer with total assets between $2-$50 million and U.S. banking organizations with assets between $2-$100 million aware of foreign ownership of their marketable long-term securities; and, U.S. nominees holding long-term marketable securities on behalf of foreign investors.

SIA's Evaluation of Treasury's Benchmark Survey

In an earlier evaluation of the Treasury's benchmark study, we noted that the turnover rates recorded for foreign investors (gross activity as a percent of holdings) were strikingly high. These published turnover rates indicated that either the Treasury's figures on current foreign flows were too high, or that foreign investors' holdings of U.S. equities were underestimated. Accordingly, we estimated foreign holdings by dividing the Treasury's flow data--gross purchases and sales of U.S. equities by foreign investors--by the highest, average and lowest institutional activity rates reported by the Securities and Exchange Commission over the same period.

Subsequently, we learned that, for practical rather than conceptual reasons, the SEC calculates activity rates in a different manner than the Treasury Department and SIA thought.1/ In essence, activity rates reported by the SEC are obtained by halving gross purchases and sales and dividing this figure by average yearly holdings.

1/ Volume in NYSE-listed issues is reported by the number of shares sold. This way of reporting volume understates activity by half because, for each sale, there is also a purchase. Turnover rates for the market as a whole are calculated by dividing volume by the number of NYSE listed shares outstanding. In the interest of consistency, gross purchases and sales by category of investor is also averaged and divided by average yearly holdings to obtain activity rates for different investor categories.

Using this definition of activity rate, SIA recalculated the holdings of U.S. equities by foreign investors. The estimates ranged from $49.1 billion to $85.6 billion of U.S. corporate equities held by foreign investors in 1979, and $63.2 billion to $115.3 billion in 1980, excluding direct investments. These ranges compare with estimates derived from the Treasury's stock and flow data of $55 billion and $75 billion of U.S. corporate equities held by foreign investors in 1979 and 1980, respectively, excluding direct investments. The latter estimates were obtained by adding the Treasury's flow data on net foreign portfolio investments during 1979 and 1980 to their estimate of foreign portfolio holdings as of year-end 1978, and applying the percentage increase in the S&P 500 as a proxy for stock price increases.

Clearly, the Treasury's estimates fall within the estimated range, although at the lower end. SIA believes that the Treasury's figures understate foreign holdings of U.S. equities. It is more likely that holdings fall within the upper range of our estimates, between $73.3-$85.6 billion in 1979 and $87.6-$115.3 billion in 1980. The Treasury's estimates correspond closely to ours if foreign investors' activity rates were equivalent to the highest rate recorded for institutional investors over the same period.

There is good reason to expect lower activity rates for foreign investors as compared to U.S. institutional investors. First, both foreign individual and institutional investors are included in the category of foreign investors, whereas U.S. institutional investor categories exclude individual investors. In general, individual investors have lower turnover rates than institutional investors. Second, foreign investors have traditionally purchased higher-capitalized, low-risk equity issues, reflecting a preference for long-term capital appreciation rather than more speculative investment opportunities. High activity rates are inconsistent with the goal of long-term capital appreciation.

Furthermore, the percent of total U.S. corporate equities held by foreign investors should be roughly equivalent to the percent of total commission business accounted for by foreign activity in U.S. equities. Commissions generated on trades done on behalf of foreign investors accounted for 7.5%-8% of total commission revenues in 1979 and 1980 of the 23 member firms from which SIA receives copies of S Forms. These 23 firms account for almost all foreign business channeled through securities firms and 56%-61% of total commission revenues received by all NYSE members doing business with the public.

Therefore, for the securities industry as a whole, foreign business accounted for roughly 5.5%-6% of total commission business in 1979 and 1980. This compares with estimates derived from the Treasury's data, by the method described above, that the percent of total U.S. corporate equities held by foreign investors amounted to 4.6% in 1979 and 4.9% in 1980. Assuming foreign investors' activity rates were equivalent to the average rate for U.S. institutions, the percent of total U.S. equities held by foreign investors, excluding direct investments, would amount to 6.2% and 5.8% in 1979 and 1980, respectively. These percentages correspond closely to the percent of total commission income accounted for by foreign portfolio activity in U.S. equities.

In short, the range between the Treasury's and SIA's estimates of foreign holdings is fairly narrow, although SIA's estimates remain somewhat higher. The remaining discrepancy may be largely explained by the inclusion of direct portfolio investment on the S Form, which indicates a need for either revising the form or continuing the benchmark studies to distinguish between portfolio and direct investment.

Benefits of Foreign Portfolio Investment

Over the past decade, the U.S. economy has been plagued by lagging capital formation, declining productivity, low savings rates, persistent balance of payments deficits, a weak dollar and high rates of inflation. The Administration's broad-reaching economic program, consisting in the main of corporate and individual tax cuts, reduced government spending, slower rates of money growth and diminished government regulation of the private sector, attests to the gravity of economic problems facing this nation. Congressional and public support for the program clearly indicate an unprecedented awareness of these problems and willingness to make necessary sacrifices. Several encouraging signs are already evident: a marked improvement in the dollar's strength, a favorable current account position and an easing of inflation.

Capital inflows from abroad provide U.S. corporations with much-needed funds for additional spending on new plant and equipment. Increased non-residential fixed investment enhances productivity and creates new jobs. If the level of foreign portfolio investment in the U.S. would fall as a result of restrictive legislation, the impact on capital formation, productivity, job creation and tax revenues would be quite harmful.

Portfolio inflows, in contributing to liquidity in the marketplace, also tend to moderate the rise in interest rates and help finance budget deficits. Reduced inflows and, consequently, higher interest rates would be particularly detrimental at a time when record high interest rates have greatly diminished the feasibility of long-term borrowing. The increase in interest costs to the U.S. Treasury would be substantial.

More generally, the Administration's program reflects a belief that excessive regulation contributes to economic stagnation, whereas allowing a freer play of market forces encourages innovation and economic dynamism. The U.S. has traditionally spearheaded efforts to dismantle existing barriers to international capital flows. A change in U.S. policy in the direction of greater restrictiveness would run directly counter to the Administration's program and the long-standing position that international flows should not be obstructed by arbitrary and often politically motivated restrictions.

Policy Implications

Those in favor of imposing restrictive requirements on foreign investors generally raise two public policy considerations:

(a) Excessive indirect control or influence by foreign investors over the U.S. economy. Portfolio investment rarely implies the same measure of influence as foreign direct investment. However, if a given U.S. corporation's stock is widely held and the majority of shareholders abstain from exercizing their voting rights, foreign portfolio investors could conceivably wield significant control;

(b) Potential disruption of the marketplace caused by a sudden increase in the supply of or demand for U.S. securities by foreign investors.

The first of these concerns is reasonable only if foreign portfolio investment is concentrated in key economic sectors; foreign holdings are large relative to the total value of U.S. corporate equities outstanding; and, foreign holdings are concentrated in the hands of associated foreign investors capable of acting in concert. None of these assumptions are borne out by available evidence.

Economic sectors in which the government has deemed it desirable to limit foreign ownership have traditionally included: domestic radio communications; atomic energy; hydroelectric power; mining on Federal lands; domestic air transport; and, coastwise and freshwater shipping. However, the Treasury's 1978 benchmark study indicates that 65% of total foreign portfolio investments in U.S. equities are concentrated in manufacturing; approximately 12% in finance, insurance and real estate; 10.6% in transportation and public utilities; 5.4% in mining and construction; 5% in wholesale and retail trade; and, 2% in all other industries. Foreign holdings of U.S. equities do not appear to be concentrated in key sectors at this point.

Furthermore, foreign holdings of U.S. equities in aggregate accounted for only 6.2% of total U.S. corporate equities outstanding as of year-end 1979 and 5.8% as of year-end 1980 according to SIA's estimates, assuming foreign investors' activity rates were equivalent to the average of activity rates recorded for U.S. institutional investors over the same period. Under this assumption, European investors accounted for 3.7% of the total value of U.S. corporate equities outstanding in 1979 and 3.6% in 1980, with Switzerland and the U.K. collectively accounting for 2.4% in both 1979 and 1980. Canadian investors held an estimated 0.9% of total U.S. corporate equities outstanding in both years. Asian investors held 0.9% and 0.7% in 1979 and 1980, respectively, with OPEC members accounting for slightly more than half of the holdings by Asian investors. (See Table on page 7.)

In view of the lack of concentration of foreign portfolio investment in the U.S. in key sectors or by nationality of investor, and the small amount of foreign holdings relative to the value of total U.S. corporate equities outstanding, there is no current danger of excessive influence by foreign investors over the U.S. economy.

Sudden increases in the supply of or demand for U.S. securities by foreign investors is theoretically possible. According to SIA's estimate, foreign investors in aggregate account for between 6-7% of

1979

Estimated Dollar Value of U.S. Corporate Equities Held, and Percent of Total U.S. Corp. Equities Outstanding Accounted for, By Foreign Investors*
($ Millions)

Assumed Turnover Rate:	High: 44.5%		Average: 29.8%		Low: 25.5%	
	Holdings	%	Holdings	%	Holdings	%
Europe	$29,673.03	2.5%	$44,310.40	3.7%	$51,782.35	4.4%
Bel-Lux	1,147.19	0.1	1,713.09	0.1	2,001.96	0.2
France	3,243.82	0.3	4,843.96	0.4	5,660.78	0.5
Germany	3,684.27	0.3	5,501.68	0.5	6,429.41	0.5
Netherlands	1,677.52	0.1	2,505.03	0.2	2,927.45	0.2
Switzerland	11,066.29	0.9	16,525.17	1.4	19,311.76	1.6
United Kingdom	7,716.85	0.6	11,523.49	1.0	13,466.66	1.1
Canada	7,173.03	0.6	10,711.41	0.9	12,517.65	1.1
Latin America	5,102.25	0.4	7,619.13	0.6	8,903.92	0.7
Bermuda	1,583.15	0.1	2,364.09	0.2	2,762.75	0.2
Neth. Antilles	1,774.16	0.1	2,649.33	0.2	3,096.08	0.3
Asia	6,804.49	0.6	10,161.07	0.9	11,874.51	1.0
Hong Kong	1,150.56	0.1	1,718.12	0.1	2,007.84	0.2
Japan	1,457.30	0.1	2,176.17	0.2	2,543.14	0.2
"Other Asia"**	3,813.48	0.3	5,694.63	0.5	6,654.90	0.6
Total	$49,056.18	4.1%	$73,255.03	6.2%	$85,607.84	7.2%

Source: U.S. Treasury Department

* Market Value of total U.S. Corporate Equities Outstanding as of Year-End 1979: $1,188.3 billion

** Countries included are: Bahrain, Iran, Iraq, Kuwait, Oman, Saudi Arabia, the United Arab Emirates

1980

Estimated Dollar Value of U.S. Corporate Equities Held, and Percent of Total U.S. Corp. Equities Outstanding Accounted for, By Foreign Investors*
($ Millions)

Assumed Turnover Rate:	High: 59.3%		Average: 42.8%		Low: 32.5%	
	Holdings	%	Holdings	%	Holdings	%
Europe	$39,006.75	2.6%	$54,044.39	3.6%	$ 71,172.31	4.7%
Bel-Lux	1,402.19	0.1	1,942.76	0.1	2,558.46	0.2
France	4,193.93	0.3	5,810.75	0.4	7,652.31	0.5
Germany	4,476.39	0.3	6,202.10	0.4	8,167.69	0.5
Netherlands	1,908.09	0.1	2,643.69	0.2	3,481.54	0.2
Switzerland	15,113.83	1.0	20,940.42	1.4	27,576.92	1.8
United Kingdom	10,505.06	0.7	14,554.91	1.0	19,167.69	1.3
Canada	9,860.03	0.7	13,661.21	0.9	17,990.77	1.2
Latin America	5,951.94	0.4	8,246.50	0.5	10,860.00	0.7
Bermuda	2,282.46	0.2	3,162.38	0.2	4,164.62	0.3
Neth. Antilles	1,595.28	0.1	2,210.28	0.1	2,910.77	0.2
Asia	8,037.94	0.5	11,136.68	0.7	14,666.15	1.0
Hong Kong	1,590.22	0.1	2,203.27	0.1	2,901.54	0.2
Japan	1,601.18	0.1	2,218.46	0.1	2,921.54	0.2
"Other Asia"**	4,452.78	0.3	6,169.39	0.4	8,124.62	0.5
Total	$63,204.05	4.2%	$87,570.09	5.8%	$115,323.07	7.6%

Source: U.S. Treasury Department

* Market Value of total U.S. Corporate Equities Outstanding as of Year-End 1980: $1,516.12 billion

** Countries included are: Bahrain, Iran, Iraq, Kuwait, Oman, Saudi Arabia, the United Arab Emirates total public volume on the NYSE. However, it is unlikely that unassociated foreign investors would simultaneously shift their investment strategies in the same way. Furthermore, given the U.S. financial markets' depth and liquidity, sudden increases in the supply of or demand for U.S. securities could readily be absorbed.

In summary, SIA does not believe that the concerns often expressed about foreign portfolio investment are warranted. Additional restrictions would serve little constructive purpose. These concerns would be more justified if future foreign holdings become more concentrated by nationality of investors or in key sectors of the economy. However, given shortcomings in the Treasury's data on foreign portfolio flows and holdings, such developments might go undetected for an unduly long period. Therefore, SIA strongly supports efforts to improve the Treasury's data collection techniques.

Recommendations

Improving the Data

Several steps could readily be taken to improve the Treasury's S-Form. The Treasury Department should clarify and publicize its guidelines concerning transactions executed on behalf of foreign investors. If policymakers are primarily concerned with the origin of foreign portfolio funds, the origin of the order should be reported on the basis of customer residence.

Additionally, the Federal Reserve Bank of New York should play a more active role in reviewing S Form data and verifying unusually large reported transactions or trades done on behalf of investors domiciled in foreign countries. The Federal Reserve could chart general trends in the average dollar value of transactions between U.S. and foreign nationals by location of foreign investors, and review substantial departures from these trends. Such a review would not be unduly time-consuming or costly. Similarly, the Treasury Department should institute more effective procedures for enforcing compliance from firms which may be unaware of their responsibility to file an S Form.

Greater efforts should be made by reporting firms to distinguish between direct and portfolio investments.2/ Individuals recording data on the S Form cannot realistically be expected to calculate the percentage of a given company's shares outstanding accounted for by each trade executed on behalf of a foreign customer. However, a level can be set above which investments could possibly be classified as direct and reported separately from the S Form.

2/ Foreign direct investment takes place when a single foreign business, person or associated group of persons owns 10% or more of a U.S. enterprise. Foreign portfolio investment includes foreign investment in the U.S. amounting to less than 10% of a U.S. enterprise.

Apart from inaccuracies, this Subcommittee has questioned whether the Treasury's present method of collecting and reporting data on foreign portfolio investments addresses the public policy issues raised by such investment. It is impossible to determine the degree of concentration of foreign portfolio investments in particular industries on the basis of information reported monthly to the Treasury. The inclusion of transactions done on behalf of U.S. nationals residing abroad on the S Form also renders the data less useful for determining the degree of foreign investors' influence over the economy, although it is important for balance of payments purposes. If the percentage of total foreign business accounted for by U.S. nationals residing abroad is substantial, concern about undue foreign influence may be exaggerated.

For public policy purposes, it may be desirable to have firms provide industry breakdowns on transactions executed on behalf of foreign investors. This would certainly enable the Treasury to monitor the degree of concentration of foreign portfolio investment in key industries more effectively. At present, the five-year benchmark study is the only source for such information.

However, if industry breakdown reporting requirements are instituted, the reporting burden falling on firms would be substantially increased. It would be costly and time-consuming to provide industry breakdown data. Firms would have to code each transaction individually and extensive re-programming would be required. In the interest of minimizing the costs to both the reporting firms and government regulatory bodies, we suggest:

(a) Only investments in those sectors which have a clear bearing on the national interest be broken out separately. Reporting firms would be provided with a list of U.S. industries for which separate information is sought.

The industry breakdown need only apply to U.S. corporate debt and equity instruments. An expanded S Form could consist of two sheets, one for each type of security, with the country breakdown listed vertically along the left-hand margins and industrial categories listed horizontally along the top of each sheet. We suggest that country categories on the form from which trades are rarely recorded as originating be eliminated from the S Form. A small section might be added, instructing firms to report the total value of trades done on behalf of foreign customers residing in countries not specifically listed on the form.

(b) Periodic studies would be preferable to requiring industry breakdowns on a regular basis. At some regular interval, perhaps quarterly, a number of filing organizations could be randomly selected and an industry breakdown of their foreign orders would be reported.

Greater accuracy in the Treasury Department's benchmark study, and more consistency between estimates of foreign holdings and current flow data, are clearly indicated. We suspect that a partial cause of the understatement of holdings stems from incomplete compliance on the part of firms required to file survey reports. The benchmark surveys should continue to be conducted every five years. Finally, it would be worthwhile to create a private sector task force to assist in setting up the next Treasury benchmark study.

Other Issues

In addition to requesting SIA's comments on the accuracy and completeness of the Treasury's data survey efforts, the Subcommittee on Commerce, Consumer and Monetary Affairs asked us to respond to the following set of questions:

(A) Could deficiencies in the Treasury International Capital System have contributed to the large discrepancies between various estimates of frozen Iranian assets and to the statistical discrepancy recorded for the U.S. balance of payments?

As the bulk of frozen Iranian assets was in the form of bank deposits, SIA is not qualified to evaluate the extent of discrepancies in estimated Iranian assets accounted for by unrecorded portfolio inflows. Commercial banks would be better able to identify such underreporting errors.

A significant portion of the balance of payments discrepancy could very likely reflect unrecorded capital inflows. We concur with the opinion expressed in the Progress Report of the Interagency Work Group on the Balance of Payments Statistical Discrepancy that commodities transactions might account for sizeable capital inflows. Such transactions are not reported on any form at present. The Progress Report also notes that reporting of private placements of debt securities on the S Form warrants attention. If a number of organizations required to file S Forms -- non-banking concerns as well as financial intermediaries -- are in fact unaware of this responsibility, such omissions might also account for some part of the balance of payments discrepancy.

(B) What is SIA's estimate of OPEC holdings in the U.S.?

OPEC holdings of U.S. securities generate considerably more concern than investments by other categories of foreign investors, for several reasons. A substantial portion of OPEC members' portfolio investments consist of government holdings rather than investments by private individuals and can potentially be manipulated for political purposes. Furthermore, OPEC countries are regarded by some U.S. citizens as adversaries. In addition, it is often suggested that OPEC members' investment activities and plans warrant particularly close attention because of the amount of funds available for investment.

However, available data do not validate these fears. Admittedly, OPEC holdings of U.S. equities are substantial in absolute terms; according to SIA's estimate, holdings by investors domiciled in countries included in the Treasury's "Other Asia" category, the bulk of which are OPEC members, ranged from $3.8-$6.7 billion in 1979 and from $4.5-$8.1 billion at year-end 1980. However, estimated holdings by "Other Asia" countries accounted for a mere 0.3%-0.6% of the $1.2 trillion of total U.S. corporate equities outstanding as of year-end 1979, and the same percentage range for the $1.5 trillion of U.S. corporate equities outstanding as of year-end 1980.

Furthermore, portfolio investments by OPEC members far outweigh direct investments and the Treasury's most recent benchmark study does not indicate that OPEC investments are concentrated in sensitive sectors of the U.S. economy. Finally, it is worth noting that many analysts foresee considerable contraction in OPEC current account surpluses over the next decade.3/ If this contraction takes place on the scale projected, funds available for investment abroad will be greatly diminished.

(C) Is ownership of stock by OPEC governments more or less destabilizing than ownership of more liquid assets?

This questions reflects the assumption that equities are relatively illiquid instruments. An investment in equities does not represent commitment of funds for a given length of time, and should not be thought of as substantially less liquid than Treasury bills and equivalent short-term investment vehicles. This is particularly true for foreign investors, who are not subject to a capital gains tax. Hence, holdings of equities by OPEC governments would be neither more nor less destabilizing than holdings of traditional short-term instruments.

3/ See "Oil Prices Sliding," in World Financial Markets, June 1981; and, "Surplus to Deficit?", in Barron's, July 20, 1981.

Mr. ROSENTHAL. Our first witness is Mr. David Mizrahi, editor and publisher of MidEast Report.

STATEMENT OF DAVID TOUFIC MIZRAHI, EDITOR AND PUBLISHER, MIDEAST REPORT

Mr. MIZRAHI. Mr. Chairman, honorable members of the subcommittee, ladies and gentlemen, MidEast Report is honored to have the rare opportunity to participate in the Subcommittee on Commerce, Consumer, and Monetary Affairs' hearings on the adequacy of the Treasury Department's Middle East OPEC investment data collection efforts.

MidEast Report, of which I am editor and publisher, was first established in New York in 1967. It is a newsletter specializing in Middle East affairs. Its subscriptionship includes large corporations, industries and banks, and Government agencies in this capital city, as well as government ministries and prominent business merchants in the Middle East.

In addition, I personally have maintained good rapport with high Arab officials, especially in the field of the treasury, finance, and economy.

We would like to clarify, before this honorable subcommittee, some of the salient factors of Middle East OPEC investment in the United States and try to identify at the same time why the statistics, thus far released by the Treasury Department, are not, to our mind, an adequate reflection of the real magnitude of this investment.

One, Middle East OPEC investment in the United States: The U.S. Treasury Department has indicated that, at the end of 1980, the Middle East oil exporters have invested a total of $51,318 million in the United States out of total OPEC investments of $61,837 million made by the Organization of Petroleum Exporting Countries.

That, in effect, means that out of $6 invested by all the 13 OPEC members in this country, $5 came from its Middle East members.

The real figures, in our opinion, are much higher. They surpass, easily, the $100 billion mark, conservatively speaking, for all the Arab countries—more specifically Saudi Arabia, Kuwait, the United Arab Emirates, and Qatar.

These are invested in certificates of deposit, stocks, bonds, real estate, and other tangible assets. Total Eurodeposits by Middle Eastern investors in the world are estimated at around $110 billion.

However, in private talks with Arab officials, I can say that in all practicality Arab investment in this country could be in excess of $150 billion, perhaps close to $200 billion.

Two, Middle East OPEC investment in U.S. equities: A very well placed Arab source in the gulf told me that, "I feel comfortable in saying that Arab government portfolio investments in the U.S. stock exchanges aggregated some $15 billion."

Those are in American securities and stocks. The Treasury Bulletin has put those investments at $688 million at the end of last year for all Middle East OPEC investments in U.S. stocks. The Securities Industry Association estimated that "other Asian countries"—meaning Bahrain, Iran, Iraq, Kuwait, Oman, Saudi Arabia, and the United Arab Emirates—have invested in 1980 anywhere between $4.45 billion and $8.12 billion in U.S. corporate equities. We still are of the opinion that even these latest figures are on the conservative side.

Since, the article by syndicated columnist Dan Dorfman revealed on May 31, 1981, that Kuwait, as of November 28, 1980, had five equity portfolios aggregating a market value of $3.7 billion. And that, incidentally, was managed by Citibank alone.

You can well imagine, I am sure, that with the increased oil revenue, the total numbers for all the Middle East OPEC nations would by far surpass the $8.12 billion mark estimated by the Securities Industry Association.

Three, Treasury statistics on Middle East OPEC investment: The U.S. Treasury, in all practicality, is unable to obtain highly accurate and comprehensive data on Middle East OPEC country investments in the United States. Because a good portion of those investments is being made through third parties, including foreign banks and companies established in the Caribbean region, in Lichtenstein, Luxembourg, or Panama.

Four, percentage of total Middle East OPEC investment in United States: About 60 percent of all Kuwait's surplus reserves and more than 40 percent of Saudi Arabia's surplus reserves are invested in the United States in U.S. dollars. Middle East OPEC investments in gold were estimated at 30 million ounces at the end of 1979, which today would aggregate $13.5 billion on average.

I have to emphasize here that at the end of 1979 and the beginning of 1980 there was a rush on gold which placed the price of gold on January 21 at its highest of $850.

This was a time when the American hostages were held in Iran, the Soviets had invaded Afghanistan, and there was what they call the Mecca incident in Saudi Arabia.

In addition, Kuwait has invested more than $750 million in U.S. real estate.

Five, Middle East OPEC countries' diversification policy: The Middle East OPEC countries cannot invest all their holdings in U.S. dollars. They have to diversify. So far, nothing indicates that they have put pressure in the world markets on the dollar. It is in their best interests to upkeep the value of the dollar, the currency in which they are being paid for their oil exports and the currency that constitutes the bulk of their surplus reserves.

Six, Middle East OPEC investment strategies: All of the Middle East OPEC countries, more or less, adopt the same strategy in their investment policies. Because of the political uncertainties, a good portion of those investments is in liquid assets, such as Treasury notes, bank deposits, et cetera.

However, Kuwait, which is less in need of liquidities, tends to invest in long-term assets such as bonds and real estate. The Saudis, nonetheless, have invested mostly in bonds and in private placements in favor of large American corporations such as IBM, General Motors Acceptance Corp., Schering-Plough, American Telephone & Telegraph, and a dozen other American utilities.

Seven, impact of Middle East OPEC investments on U.S. economy: Those investments, on the whole, have a good impact on the U.S. economy, because the petrodollars are being recycled back in the American money circuit. Most European investors are doing just that and this doesn't seem to have had any adverse effect on the U.S. economy.

To the contrary, Kuwait's insistence on more aggressive trading of its billions stems only from the natural desire of an investor to have a better return on his investment. No more, in our opinion.

Eight, reasons for the Treasury Department's secrecy policy: The U.S. Treasury is pursuing a policy of strict secrecy because of an agreement arranged in early 1974 between then Treasury Secretary William E. Simon and the Saudi and Kuwaiti Governments under which the United States assured the two Arab governments confidentiality in reporting data on them only by region.

Mr. Simon said at that time: "The regional reporting was the only way in which Saudi Arabia would agree to the deal" for the purchase of U.S. Treasury securities.

The Treasury Department, in agreeing to this policy, wanted to encourage more Arab government investment in this country. The Middle East governments only operate in total secrecy. That is also true of all their investments even in their own countries.

Obviously, secrecy is not in the best interests of the American public. But consider the alternative; that is, a reduced Arab investment here. Middle East investors are of the opinion that secrecy is the only prerequisite for their investment here or elsewhere.

I wouldn't say that public disclosure is going to stop all Arab investment in the United States. But, I will say, it will certainly affect this investment severely in the future.

However, it is my opinion that in the future long term it won't affect it that much. By future, I mean specifically the short term.

Thank you, gentlemen.

Mr. ROSENTHAL. Mr. Mizrahi, you place Arab government portfolio investment in the U.S. stock market at $15 billion. What do *you* estimate Arab private portfolio stock to be?

Mr. MIZRAHI. Oh, I would guess anywhere between $7 and $8 billion.

Mr. ROSENTHAL. You told us some of the large U.S. corporations in which the Saudis have made private placements or loans. Do you know the names of all of those? Can you tell us more than what you told us early on?

Mr. MIZRAHI. There were some private placements going as far back as 1973 or 1974. It started with IBM, as far as I recall, but they started with triple A American corporations definitely.

Now they are shifting. In the case of Schering-Plough, that was arranged this spring, as a matter of fact. Mostly they take triple A corporations and I think so far those placements have been made, as far as I know, with about 25 American corporations, most of them in the Fortune 500.

Mr. ROSENTHAL. The subcommittee staff has reviewed many documents in which several Middle East OPEC nations have apparently made it clear unless, as you stated, preferential treatment were given to their investments by the U.S. Government there will be no incentive to produce such oil.

Do you have an opinion as to what the likelihood would be if such implied threats were carried out?

Mr. MIZRAHI. I think they would in the beginning reduce production of oil, yes, but in my opinion again, although oil production has something to do with politics, I think mostly it has also to do with internal economics and politics.

Consequently, take a country like Algeria, because all the OPEC countries are not Saudi Arabia. Iraq is in need of money, Algeria is in need of money. There are other countries, Arab countries, that need money so their oil production policy is not going to be affected by external factors only.

There are some pressing needs domestically that will compel them to produce.

Mr. ROSENTHAL. What about Saudi Arabia?

Mr. MIZRAHI. Saudi Arabia, I think, is in a position to produce less. As a matter of fact, it is my opinion that if the AWACS deal doesn't go through, the Saudis would be tempted to cut some oil production as a first reaction.

Mr. ROSENTHAL. What about if there were some pressure within the United States from either the Congress or the public to limit the agreement Mr. Simon made for confidentiality and try to force the Treasury Department to release some of this country-by-country information?

What do you think would take place in Saudi Arabia or Kuwait?

Mr. MIZRAHI. They would be upset, which means in practicality again that they would tend to reduce their investment here but as you once stated, Congressman, they have $200 billion. They are going to get more and more revenues so what are they going to do with all this money? They cannot put all this money in Europe or Japan.

So it is a consequence that the bulk of the OPEC money is going to be invested here no matter what. That is my opinion and the opinion of high Arab officials with whom I have discussed this matter.

Mr. ROSENTHAL. I think you told us Kuwait had real estate investments of $750 million.

Mr. MIZRAHI. Yes.

Mr. ROSENTHAL. Can you tell us where they are? Can you tell us something about it?

Mr. MIZRAHI. In New York, in Atlanta, Ga., in North Carolina, in California, in Dallas, in New Orleans.

Mr. ROSENTHAL. Is it continuing to grow?

Mr. MIZRAHI. Yes.

Mr. ROSENTHAL. You set Middle East OPEC investment at the $100 billion mark. Does this reconcile with the figures you published in your February 1981 report which placed Arab assets in the United States in American banks in Europe between $150 billion and $200 billion?

Mr. MIZRAHI. I have written this $100 billion but I have added that the figure actually exceeds that, and I said it is anywhere between $150 billion, close to $200 billion, in my opinion.

Mr. ROSENTHAL. Is there anything we should know about in Kuwait or Saudi investments; that is, the form they take, the method of financing and investment strategies?

Is it different than the average real estate investment in any way?

Mr. MIZRAHI. No. What they do, I am talking now about the Government of Kuwait, they have many banks as advisers—the real estate department, let's be specific, of Chase Manhattan Bank or Morgan Guaranty in New York.

So these people are on the alert and they get in touch with the Kuwaiti Government and they tell them about this or that opportunity. So the Kuwaiti Government, like any other investor, puts up the down payment and gets the rest in the form of mortgage.

There is nothing unusual. Maybe what is unusual is the magnitude of the investment which goes anywhere from $4 and $5 million and up to $200 million.

Mr. ROSENTHAL. When you gave the estimate of $150 billion to $200 billion, can you give us a breakdown by countries?

Mr. MIZRAHI. Let me see.

Mr. ROSENTHAL. Also, tell us the source for that breakdown because we are not able to get that from the Treasury Department.

Mr. MIZRAHI. Saudi Arabia was estimated to have invested some $100 billion in the United States. Kuwait, close to $55 billion. The United Arab Emirates, about $40 to $45 billion.

Mr. ROSENTHAL. What is the basis of that information that you provide for us?

Mr. MIZRAHI. It is a high source in the gulf. I cannot go beyond that.

Mr. ROSENTHAL. We are unable to get that information.

Mr. MIZRAHI. You mean the United States?

Mr. ROSENTHAL. No. This committee. The Treasury Department won't give it to the CIA, won't give it to the Federal Reserve Board, but you seem to be particularly fortunate in having access.

Mr. MIZRAHI. I must tell you most of my information comes from Arab sources. I honestly didn't try to call American sources because I like to think that my source is very good so I don't want to be denied or to dilute my information by some other statement.

But I can tell you, Your Honor, that this is information I got from one of the highest financial sources in the Persian Gulf. I cannot go beyond that statement.

Mr. ROSENTHAL. Mr. Hiler?

Mr. HILER. Thank you, Mr. Chairman.

I would like to go through a couple numbers with you because there are so many thrown around—$150 billion to $200 billion OPEC investments in this country. Of that amount, how does that break down with respect to type of investment? In other words, portfolio: What percentage represents stocks, bonds, Treasury bills? Do you have any kind of breakdown?

Mr. MIZRAHI. No, sir. I have only what the Treasury published. It has been very difficult for me to get a breakdown of those figures. You can tell some of these figures relate to stock, mostly stocks and real estate; but, really, for bonds and Treasuries, I cannot. In fact, I didn't even bother to go into those details. I was interested in the bulk.

Mr. HILER. Concerning the bulk, do you think $150 billion to $200 billion in the overall U.S. economy and asset structure has the potential to be a stabilizing force? Maybe you could describe how that could be.

Mr. MIZRAHI. In this country? In the United States?

Mr. HILER. Yes.

Mr. MIZRAHI. You see, in my conversation with Arab officials, I didn't detect—I go to the gulf often, four or five times a year—I have never detected something unreasonable about this investment. It is like any other investor. They think the economy is good in this country, they think it is a good security, and they want a good return on their investment.

I have never heard any comment of destabilization or something of that nature.

On the other hand, when Arab countries want to take over an American corporation, they are not interested in placing members on the board, they are interested in their investment. Usually their representative to the board is the American lawyer who negotiated the deal.

Actually, so far as I know—that is my opinion—what they have in mind is a good return on investment and a safe place to invest.

Mr. HILER. As you say, that money has to go somewhere.

Mr. MIZRAHI. Yes. As a matter of fact, I can read to you a statement made by a high Arab financial official who told me there is no way but the United States, and that is why Kuwait has placed 60 percent of its surplus in this country and Saudi Arabia more than 40 percent.

Mr. HILER. What benefits would accrue to the United States?

Mr. MIZRAHI. Recycling of petrodollars that we are paying for our imports of oil.

You see, foreigners are also investing in this country—the British, the Dutch, the Canadians, so why not Arab money? That is my attitude.

Mr. HILER. I can remember several years ago there was great concern whether the international monetary system would be able to handle the huge number of petrodollars.

Do you think we have overcome those concerns people had a few years ago?

Mr. MIZRAHI. I think we can handle those petrodollars. Who else can? We can handle them.

You see, sir, there is a problem. The Arabs or the OPEC countries have surpluses of over $200 billion. Where do you think they are going to place all this money? Can they convert those rials? They are paid for their oil in U.S. dollars and nothing else, so they have to get this placed in their account in the United States in American banks.

Now to take those dollars and place them in Switzerland or in Germany or in Japan they have to convert those dollars into local currency, meaning deutsche marks, yen or pounds or Swiss francs.

Do you think these countries are ready to absorb all that money in their banks—Germany, Holland, Britain? That would disturb their monetary system. The only country that could absorb those petrodollars would be the United States. What is left over could be diversified in some other countries but basically, and that is my position, the United States is the only major outlet for petrodollars.

Mr. HILER. So if somehow the petrodollars did not flow here that could have a very destabilizing effect?

Mr. MIZRAHI. Yes, on other countries, but even they would tend to reconvert those deutsche marks in U.S. dollars and redeposit them here.

Mr. HILER. There is a continued reference to discrepancies between the aggregate inflow of funds on the one hand and the lack of investment information on the other.

Is it your considered judgment that anyone in the U.S. Government really has an accurate handle on where the money is invested?

Mr. MIZRAHI. I wouldn't say accurate. An idea, yes. Accurate is very difficult because I know how they operate. They form companies. Mostly now the money is coming through companies formed in the Caribbean. These companies are investing here. These companies are usually under a name like DTM Corp. or whatever, so there is no way of knowing where this money is coming from. Moreover, those investments will come from Deutsche Bank or Union Bank of Switzerland or Barclays of London. Even the guy who places in Switzerland the order to buy, doesn't know where the source of funds is or where it came from.

That is why, in answer to your question, I really am not sure they would know exactly, precisely, where this money is coming from but they could have an idea; yes.

Mr. HILER. Do you think many of the funds are invested in commodities in this country?

Mr. MIZRAHI. There are some funds invested in commodities, yes, especially silver and wheat because the Arabs like to trade in commodities; as in gold.

Mr. HILER. One final question, maybe with two parts.

Do you think the OPEC countries are being unreasonable in their demand for secrecy, and what do you think we would have to gain in this country by full disclosure?

Mr. MIZRAHI. I want to be specific when you say OPEC countries. OPEC is made up of 13 members of which seven are Arab countries. I would like to talk about the seven Arab countries.

Mr. HILER. Fine.

Mr. MIZRAHI. I was born in Lebanon, I speak Arabic fluently. The Arabs like secrecy. It is inbred in the Arabs because maybe of their history, maybe because—if you read their history it is filled with intrigues, conspiracies and plots. It is inbred in them. They don't like to publicize.

The second reason, in my opinion, is that there is an Arab saying, to live in peace let's live off the limelight. They don't like the limelight because the limelight brings trouble, problems.

The third one—this is my opinion and you may smile about it, but they understand it—they are very much afraid of the evil eye which means envy, jealousy.

To me those are the three main reasons.

Suppose you are a multimillionaire and you want to say to everybody how much you have. They don't like that. That is the feeling. First of all, the world knows about it. Second, they don't like the Arab countries to know what they have. That is basically the attitude.

Furthermore, particularly in this country, they feel that the American press is not very pro-Arab. Consequently, the American press and media would jump on any opportunity to assail the Arabs.

Mr. HILER. Do you think we would gain by full disclosure?

Mr. MIZRAHI. We, the United States?

Mr. HILER. Yes.

Mr. MIZRAHI. I would think yes. I am being very objective. I still remember the incident when President Carter in November 1979, froze Iranian assets. We had to wait for maybe a whole week to really assess what the Iranian assets were in this country. That really put us at a disadvantage vis-a-vis the Khomeini regime.

Mr. HILER. I yield back.

Mr. ROSENTHAL. Mr. Daub.

Mr. DAUB. Thank you, Mr. Chairman.

What would you say that the overall Arab investment is worldwide, approximately?

Mr. MIZRAHI. Worldwide?

Mr. DAUB. Not just in the United States but outside their borders worldwide.

Mr. MIZRAHI. $300, $320 billion.

Mr. DAUB. So the substantial amount—is it $100 or $200 billion that you estimate—is in this country?

Mr. MIZRAHI. I said between 150, close to 200.

Mr. DAUB. So two-thirds, somewhere between half and two-thirds of their worldwide investment?

Mr. MIZRAHI. Sixty percent.

Mr. DAUB. Sixty percent in this country?

Mr. MIZRAHI. Yes.

Mr. DAUB. I just want to get a clarification. Do you have your statement in front of you? In the section entitled "No. 1" you have the figure of the $100 billion mark, then you have 100 in deposits.

Mr. MIZRAHI. In the world; yes.

Mr. DAUB. Is there a difference of 10 or is there a difference of 300-plus?

Mr. MIZRAHI. I said Eurodeposits. All investments are not Eurodeposits; I mean by deposits in the banks.

Mr. DAUB. Are you including in the 300-plus the depositing figure of 110 outside of the seven countries? I am talking about their money.

Mr. MIZRAHI. Eurodeposits, in my opinion, sir, are deposits in Europe, mostly in branches of American banks in Europe.

Mr. DAUB. Is that another way that the funds get here?

Mr. MIZRAHI. Yes.

Mr. DAUB. If we had a disclosure system—and my colleague, Mr. Hiler, alluded to it in his earlier question—what would happen, in your opinion, if those funds absorbed themselves into other places instead of into the Eurobanks on their way here? Would full disclosure create less Arab/OPEC investment in this country?

Mr. MIZRAHI. At the first stage; yes.

Mr. DAUB. Thereafter?

Mr. MIZRAHI. After, I would say, it would tend to return to normal.

Mr. DAUB. Because this is, as you said, the one place where it all has to come no matter what?

Mr. MIZRAHI. Yes. It is a matter of fatality.

Mr. DAUB. Why does the Treasury Department have such a tough time verifying such a large discrepancy between your sourced figures from a high place? Do they have some high-placed source too? What is the problem, in your opinion?

Mr. MIZRAHI. I think that Treasury is only tabulating what is coming in officially and openly, but as I told you, there are many ways like transfer of funds, you have to bear in mind that Arab governments don't only trade or have business with American banks. They have business with many European banks.

Suppose a transfer comes from the Union Bank of Switzerland to this country as an order placed by an Arab investor. Suppose this transfer may be made to a Swiss corporation in New York or Chase.

Chase Manhattan Bank has no way of knowing the origin of the funds. As far as Chase is concerned, this money came from a Swiss bank.

To answer your question, this money cannot be all deposited in American banks. It could come through other banks or other outlets also, like finance companies.

Mr. DAUB. Give me your opinion, if you would, with your knowledge of the East, how much of the $150 to $200 billion is of that origin or that source, that is, a third party, if you will, or more difficult to identify source type of investment in this country.

Mr. MIZRAHI. I honestly can only guess.

Mr. DAUB. Would most of it come that way?

Mr. MIZRAHI. No.

Mr. DAUB. Most of it would come more directly like the purchase of a bank?

Mr. MIZRAHI. This has to come directly. When you buy real estate, when they buy Treasury bonds or Treasury notes, they have to be official. When they arrange for a private placement with American companies such as General Motors, it has to be official.

But there are also other ways.

Mr. DAUB. But that must be only $51 billion?

Mr. MIZRAHI. That is the official figure in my opinion. I haven't read that in the papers here. There is something very interesting in the Arab world. The governments get involved into private banks. The governments in the Arab world have a 20 percent share in a private bank. Take the Saudi International Bank. Fifty percent of the shares are held by the Saudi Arabian Monetary Agency which is the central bank of Saudi Arabia.

So Saudi International Bank in London is a commercial bank. So this, in my opinion, could also be an outlet for Saudi funds—I am speaking very openly now.

Mr. DAUB. I appreciate your candor.

Mr. MIZRAHI. There are other banks, too. I am citing this as an example but the Kuwaitis are involved in many banks.

Mr. DAUB. But you won't speculate on the difference being, let's say, more than 51 percent of that source as opposed to the identifiable amount of $51 billion and that discrepancy, the $150 to $200 billion you know is over here?

Mr. MIZRAHI. A percentage, I would guess.

Mr. DAUB. Half and half?

Mr. MIZRAHI. I think more than half.

Mr. DAUB. Thank you very much.

Mr. ROSENTHAL. Just one other point I want to try to develop, if I can.

Do you sense a difference in investment strategy between Arab private investors and Arab governments?

Mr. MIZRAHI. Yes.

Mr. ROSENTHAL. What is essentially the difference?

Mr. MIZRAHI. You see, Arab governments, sir, are not going to buy banks in this country. Private Arab investors are going to. The difference is in the magnitude and the potential for investment. The private Arab investors are buying either banks or real estate or companies.

I don't see anything else, whereas, the Arab governments are buying Treasury notes, Treasury bills, putting deposits in the bank. So are, by the way, private Arab investors.

Mr. ROSENTHAL. The one significant difference in the point I have been concerned with is the Arab private investors are principally motivated by the financial return.

The Arab governments want that but there are political considerations.

I am reading from an article in the September 14 Wall Street Journal where it tells the story of the Iraqi oil minister "reportedly urges other Arab governments to withdraw oil dollars from the United States for political reasons" because he is unhappy with U.S. policy.

Mr. MIZRAHI. Correct.

Mr. ROSENTHAL. I wonder if you could offer any thought or comment on the question or problem, if it is a problem, whereby Arab governments might at some times be motivated by political rather than by other considerations and might withdraw large sums of money from the United States. What could the scenario be if that happened in a short period of time and significant sums were involved?

Mr. MIZRAHI. Do you have a minute? I can read to you what I had in an interview in an Arab country from a high Arab financial official. Perhaps it will shed some light on your question, sir.

He told me and it is here, "To withdraw all our holdings and deposits from the United States is technically impractical." This high financial official added: "I want to say technically since you have currency you should have a place where to put this currency. You should have a market like the United States. If you withdraw deposits from the United States, you will have to convert them into other currencies. That means you have to buy deutsche marks, Swiss francs or Japanese yen.

"So are these markets sufficient and capable of swallowing all those dollars? Do these markets have the same qualifications and security as we have in the United States? Certainly not."

I am quoting him, again, "Because the Americans have at least 70 percent of the total negotiable instruments in the world."

This official went on to say, "The dollar is the main money market. The only reserve currency now we have in the world.

"So technically it is very difficult to shift dollar holdings for other currencies.

"It is very difficult," he added, "to find a substitute for the American market, besides will other governments accept that situation? Will the Deutsche Bundesbank accept to take all the money that comes or to buy such deutsche marks as we want?"

Mr. ROSENTHAL. Let me just ask this. Is it your view that the advantages of the U.S. financial and banking system would cause these Arab countries to maintain their funds in the United States, notwithstanding any political call for withdrawal or notwithstanding whatever the political turmoil might be at any given moment?

Mr. MIZRAHI. In my opinion——

Mr. ROSENTHAL. In other words, the man who gave you that interview was probably a finance minister rather than a propaganda minister?

Mr. MIZRAHI. Definitely not a propaganda minister.

Mr. ROSENTHAL. Suppose the political situation boiled over to the point where the finance minister were outvoted by somebody else high, the first secretary of the royal family or somebody like that.

What would happen then where the political people would say, I don't care what the financial advantages are; the politics of unity is to support the Iraqi call for withdrawal?

Do you see that as a possible scenario at all?

Mr. MIZRAHI. First of all, you noticed there was no reaction to that statement.

Mr. ROSENTHAL. I noticed that.

Mr. MIZRAHI. Second, during the oil embargo in 1973, you will notice the Arabs have not withdrawn their money from this country. Granted, this money was not as fabulous as it is today but it is a fact that even though they declared an oil embargo against the United States the Arabs have not withheld their money.

The statement by the Iraqi oil minister, we have heard such statements all over the years, and yet the Arabs have not withdrawn their money from the United States.

There might be a situation whereby as a shock effect some money will be withdrawn. There will be a situation—I am particularly thinking about the Iraqis—where you will see perhaps a strong reaction in which they will stop or cut oil production, but again, this is a short-term situation.

In the long term, things will go back to normal.

Mr. ROSENTHAL. I think there have been political situations where investment was inhibited by politics. A.T. & T. is no longer getting SAMA because it has been placed on the Arab boycott list.

Are there other companies in a similar situation?

Mr. MIZRAHI. I was surprised to hear that Beatrice Foods, which is on the Arab blacklist, has arranged a placement with the Saudi Arabia Monetary Agency, SAMA, but on the whole I know the first question asked when SAMA is approached by any corporation for a private placement would be, are you on the Arab boycott list?

Mr. ROSENTHAL. Why do you think they lent money to Beatrice Foods but not to A.T. & T.?

Mr. MIZRAHI. I have no answer for that.

Mr. ROSENTHAL. Thank you very much for your very enlightening testimony.

Our next witness is Mr. Christopher Story.

Mr. Story, we are delighted to have you in the United States. You have prepared one of the longest statements I have seen—ever. Without objection, the entire statement will be included in the record.

Is there something you can do to shorten this very, very knowledgeable presentation?

STATEMENT OF CHRISTOPHER STORY, EDITOR AND PUBLISHER OF INTERNATIONAL CURRENCY REVIEW AND ASSOCIATED PUBLICATIONS, LONDON, ENGLAND

Mr. STORY. Mr. Chairman, I assure you I have no intention of reading it at all.

Mr. ROSENTHAL. It obviously shows you have done a great deal of work and have a vast fund of information.

Mr. STORY. Thank you very much, sir.

Mr. Chairman, members of the committee, ladies and gentlemen: What I have done in this statement is to give you geofinancial interpretations which will put the problems that you are addressing in a broader context.

I know that there is an American penchant for identifying and quantifying everything but in a situation which has been distorting the extent that the international financial system has been as a consequence of the West's appeasement of the OPEC cartel, your ability to quantify is going to be progressively reduced to the point at which attempting to quantify is likely to prove counterproductive, if not a waste of time.

All cartels are by definition corrupt. The appeasement of the OPEC cartel by the West was a deliberate decision taken by the United States, aided and abetted, I must stress, by the United

Kingdom; opposed by the European powers led by France—until they backed down, realizing that they were wasting their time.

In my testimony I have gone back to August 1971, and I cite the famous point by Mr. George Schultz in which he rejoiced at the severance of the dollar's final link with gold, using the words that this departure had freed us to follow the domestic policies that we feel are the important ones.

I take this to be persuasive evidence that the U.S. Treasury saw enticing advantages in a global monetary regime in which no fixed impediment stood in the way of theoretically unlimited monetary creation. And I would like to add perhaps that it is somewhat ironic that the Federal Reserve and, of course, the Bank of England and the U.K. Treasury are wrestling with increasingly complex monetary targetry.

You can interpret this as an attempt by helpless monetary managers to rationalize their need for a cohesive system whereby they can persuade themselves that they are somehow controlling the expansion of liquidity.

The key point that I would like to emphasize is that the money supply expands to finance higher prices, in any economic environment which has been distorted by monopolies. I lighted upon this very elementary insight by looking at what has happened in the United Kingdom, where the labor market is controlled by monopolies.

The reason we are unable to get to grips with our problems in the United Kingdom is that after 40 years of socialism the labor market is controlled by monopolies. We have monopolies in the public sector and the labor market simply feeds falsified prices into the public sector. It is a sort of vicious circle, and the money supply expands to finance these higher prices.

Exactly the same thing has happened on an international scale since the cartelization of oil prices which the West connived in.

Projecting what has happened over the past 10 years ahead, or the next 9 years, reveals some perfectly extraordinary figures, which I have identified. The Energy Department calculates that by 1989 the price of petroleum will be $70.30; see page 7 of my testimony.

If that expectation proves correct—and it has been pretty accurate to date, although I should say that the Treasury's expectations are slightly more modest—Saudi Arabia will earn $1,690 billion between 1981–89.

This is almost exactly equivalent to the current size of the gross Euromarket as estimated by Morgan Guaranty Trust Co.

In other words, the rest of the world will have to transfer total value of the gross Euromarket to Saudi Arabia. Of course, this is absolutey incredible. It is intolerable, and yet here we are doing nothing at all apart from reducing our imports of OPEC petroleum, to stand in the way of this process.

The appeasement of the cartel, the resulting linking of the international financial system to this bonanza, this automatic monetary creation system, has produced unprecedented geofinancial distortions which have undermined the pursuit of stable policy in all Western countries, not least the United States.

I have some other calculations which I won't go into in detail but you can calculate that Kuwait would acquire something like $600 billion over the next 9 years, and so on.

I have the historical figures of the 10 OPEC countries listed in the IMF's International Financial Statistics publications. These earned $1,400 billion in 1955 to 1981, most of this earned during the last 10 years.

These figures represent the linking of the proliferation of dollars to the oil price and the fact that OPEC somehow managed to persuade all other countries in the world to pay for their imported cartelized petroleum in dollars.

This is an important point because it is something which has been totally overlooked by analysts. I can't imagine why.

What matters is in what currency is this oil paid for? If the currency is paid for in dollars, all nondollar countries must purchase dollars on the foreign exchange market in order to meet their oil remittance obligations.

The practical effect of this is to buoy the dollar up on the foreign exchange market. There is a constant transactions demand for dollars. This is easily illustrated. In 1978, when after several years of modest oil price increases and when OPEC was effectively in balance on current account and likely to run into deficit, the dollar virtually collapsed.

You will recall that Saudi Arabia withdrew funds from the U.S. financial system specifically from placements with the Treasury in order to maintain its expenditure on prior commitments.

In other words, its finances were out of gear.

Luckily the system rectified itself with another colossal explosion of the international dollar money supply consequent upon the escalation of oil prices which occurred in 1979–80; so the situation has been temporarily alleviated from the oil producers' point of view.

This does bring us to the question which was briefly addressed here and which Mr. Hiler raised earlier, of what would happen in fact if the proliferation of dollars linked to the consumption asset, namely, petroleum, were to come to an end? The consequences would be absolutely catastrophic.

Now that we have embarked upon this route there is no looking back. Deflation is far less acceptable than tolerable inflation.

Later in the testimony, I discuss critical matters which have been touched upon this morning such as to what extent is the United States prepared, in an emergency, to take action to freeze OPEC assets?

There are documents which your subcommittee has identified, which make it clear beyond doubt—I cite this in my testimony—that the Treasury stands ready to freeze Saudi assets just as much as the assets of any other country, under certain circumstances.

Clearly those circumstances have not yet arisen, but they are not difficult to envisage. Should the Saudi Arabia regime collapse, should there be an upheaval, should the revolution spread from Iran and incipiently from Egypt to Saudi Arabia, one could well imagine that circumstances could arise that the Treasury would have to invoke the International Emergency Economic Powers Act—originally—I submit—placed on the statute book against the possibility of Saudi assets needing to be frozen although in practice.

Of course, the act was applied for the first time against Iranian assets.

The Treasury, through this act, has secured the means to guard the U.S. financial system or the international dollar financial system against any sudden shocks.

Despite the familiar Treasury line which was eloquently advocated by Mr. Fred Bergsten during his tenure at the Treasury, that any sudden withdrawal of financial assets by OPEC countries would not cause severe upheavals, it is clear from the record—and notably from a recent congressional committee's report on the Iranian assets negotiations—that Treasury staff was advising the Treasury to freeze Iranian assets as early as February 1979.

They had in mind the very serious problems that could arise should Iran withdraw assets without warning. Actually, Iran did give a warning, but President Carter went ahead anyway.

Moving further into the presentation, I have tried to cover more than the patterns of investments. What I have been looking at is streams of financial flows which result from what I interpret as the Treasury's deliberate and consistent financial policy, and Saudi Arabia's association with that policy.

The Treasury has taken a number of steps to enhance and develop the close, bilateral, financial arrangement which has arisen between the United States and Saudi Arabia. Of course, going back to my original statement that all cartels are corrupt, it is obnoxious to see the Government of the greatest democratic country in the world indulging in bilateral semisecret or secret arrangements with the ruling elite in a feudal state with such colossal consequences for the rest of the world.

One of the reasons for the aura of secrecy and cloak-and-dagger revelation of information that has to be pried out of Treasury is that they don't really want you to know what is going on, any more than they want the press to know what is happening.

As you may know—you can see from my testimony that it is an established fact—the staff of the United States-Saudi Arabia Joint Commission on Economic Cooperation was originally funded from the exchange stabilization fund which is under the exclusive control of the U.S. Treasury Secretary.

It was not until 1978, when Congress found out that the Treasury was paying the salaries of the Joint Commission staff out of such nonappropriated funds, that it passed a public law in 1978, "prohibiting the Treasury from paying salaries and other administrative expenses associated with its international affairs function with Exchange Stabilization Fund moneys; in the future, such expenses will be paid from appropriations."

I take it that the Treasury sponsored the establishment of this Joint Commission. There was a military joint commission as well, about which I have been unable to locate any information at all other than two specific documented references.

But during the first 3 or 4 years of existence of the Joint Economic Commission, staff salaries were paid for out of the exchange stabilization fund.

The use of joint economic commissions to further U.S. policy objectives is not new. Such commissions were established with Egypt and Jordan, for example, as well—as an instrument of foreign policy to accelerate and enhance the appeasement process following the 1973 oil embargo.

The United States-Saudi Arabia Joint Commission is by far the most important of these commissions, and it has been greatly undercovered by the press.

I remember attending a press conference in the Cash Room of the Treasury in April 1980, which was attended by large numbers of press representatives from all over the world, including the United Kingdom.

On the platform were the Treasury Secretary of the day, Mr. Miller, and Sheikh Aba Al-Khail. They thought they were addressing a meeting which was to have discussed the activities of the Joint Commission but there wasn't one single question raised by the press, apart from the awful question I raised about the activities of the Commission. All that happened was that press representatives stood up and asked anodyne questions about the future of the dollar. Of course, it was fairly obvious by observing the Treasury Secretary and the department of the Sheikh Aba Al-Khail that they were overjoyed or at least perfectly satisfied with the reception they received at this meeting, because the press was not asking the key questions and the press had not really looked into this matter to the extent it should have done.

The purposes of the Commission are fairly clear and are also documented in this paper. It is a mechanism for insuring, through Commission-generated feasibility studies, that tendered documents are geared to U.S. specifications so that U.S. suppliers benefit from subsequent contracts.

It is an instrument for the active pursuit of the U.S. bilateral financial, economic, and commercial policies toward Saudi Arabia at the expense of foreign competitors.

The Saudis will deny that. They will say that contract inquiries are put out to contractors from other countries. The Treasury will say the same, that it puts out inquiries to three contractors; but the fact of the matter is the thrust and the purpose of the Commission is that to recycle petrodollars into the industrial complex of the United States.

In this connection there are some figures available. The overall anticipated projected value of a project for electrifying the energy grid in Saudi Arabia was estimated by Mr. Bergsten, in March 1980, as being likely to amount to $70 billion over 20 years; but the Commission staff in the Treasury—in Mrs. Bonnie Pounds' office—gave a figure of $24 billion.

So you can see, as I have said on page 19 of my testimony, the gravy train is so incredibly large that figures have become meaningless. Officials from the same department were able to quote values 18 months ago which were as much as $43 billion apart.

They just don't know what is likely to arise or to develop as a result of this initiative. But what is clear is that the Commission oils the wheels, makes it easier for the United States to procure construction and other contracts; and in this connection it is, of course, quite remarkable to an outsider that the Treasury is itself involved in placing some of these contracts.

The Treasury would appear to maintain the procurement staff specifically for that purpose.

I find that quite extraordinary. That is something that would astonish people in the United Kingdom.

The Joint Commissions' purposes have been clearly identified and on page 20 of my testimony I summarize some of the official reasons for the Commission's existence which supplement what I have already said.

Its main purpose is assisting Saudi industrialization and development while recycling petrodollars.

It is to help the Saudis to find a way to invest their large and growing financial revenues, and specifically to direct as large a proportion as possible of these revenues into the U.S. industrial economic system.

It makes a lot of sense from the U.S. point of view. It is bad news for the rest of the world. It is based on collaboration with a cartelized system which is an anathema and runs contrary to the United States well known advocacy of a free world trading system.

I would draw your attention to the incompatibility of these two positions. On the one hand, you are pursuing a deliberate bilateral, clearly defined policy which maximizes the advantages to be obtained from the monopoly which you have appeased and, on the other hand, you purport to be in favor of the development and maintenance of free trade. You can't have it both ways.

On pages 21, and subsequently, I talk about the "add-on system" and the issue of confidentiality which has been addressed by this committee and, indeed, by the Scheuer subcommittee in the past.

This summary in fact deals with what I called in an issue of International Currency Review in 1977, and subsequently, the secret agreement. It was secret. Of course, it is no longer.

The add-on system, whereby the Treasury, through the Federal Reserve Bank of New York, announces issues of Treasury securities and the Fed telephones the Saudi Arabian Monetary Agency, SAMA, and asks the question: "Do you want an additional apportionment or add-on," was originally designed to satisfy Saudi Arabia's presumed need to place an increasing portion of these petrodollars somewhere safe. But when Arab financial institutions came to hear of this arrangement, they wanted a cut of the action as well which they got and the Treasury has revealed to your subcommittee that the arrangement was later opened to all central banks.

I find that slightly hard to swallow but I can't argue because I have no better information.

The issue of confidentiality has been addressed by your subcommittee with great success and it is absolutely critical. I believe it was Mr. Bergsten who put his finger on it. He said it is very difficult to identify the difference between private and Government investments when you are dealing with certain countries.

He did not specify which countries but it was obvious what he was talking about.

One of the key reasons concerning the obsession with confidentiality by Treasury officials is that one doesn't know who owes the Saudis money. Is it members of the ruling elite, or the Government?

The dividing line between these mega wealthy individuals and the governments they belong to and participate in is unknown.

This is another sinister feature of the United States deliberate collaboration with this cartelized system. It is that when you get cozy arrangements, the benefits accrue to few. In my opinion, in the long term it is an untenable situation.

The sine qua non for the add-on agreement was confidentiality. That issue is dealt with there.

I also refer to the revolving-door syndrome, asking the question: have some U.S. financial policymakers been dazzled by OPEC's wealth? Has it affected their policymaking? There isn't a clear answer to this, but there are awkward questions which have not been answered and on pages 24 to 26 I cover that point.

Mr. ROSENTHAL. In the part of your statement where you quote: "Many, if not most, of the senior U.S. officials," is that what you are talking about?

Mr. STORY. Yes, sir; it is something that worried me and it worried a witness, Mr. Jack Blum, and I think he put it brilliantly and if I may, perhaps I could just quote one sentence.

> Wealth—especially great wealth—has a dazzling quality; and this gives rise to the possibility that U.S. policy toward OPEC and current oil price levels may well have been formulated by men who were dazzled by the prospect of acquiring a share in such wealth.

He then listed various operatives who have benefited from this situation.

> A clutch of former Ambassadors to the region, two former Central Intelligence Agency chiefs, a former Secretary of State, a former Vice President, a former Chairman of the Senate Foreign Relations Committee, a former Secretary of the Treasury, a former Under Secretary of the Treasury, and a large number of former congressional and administration officials.

To this list can be added the names of at least two U.S. former Ambassadors to Saudi Arabia.

Mr. ROSENTHAL. You probably don't understand. That is what makes us great. It is known as the free enterprise system. [Laughter.]

Mr. STORY. Revolving door, sir. It is something that doesn't exist in Britain.

Mr. HILER. May I interrupt, Mr. Chairman?

Mr. ROSENTHAL. I think you should.

Mr. HILER. Could you repeat that part of your statement about "the people"? Before that, you referred to former Secretaries of State and a Foreign Relations Committee chairman—I know he was a Democrat. I haven't heard that in a long time.

Mr. ROSENTHAL [addressing Mr. Hiler]. There are just as many Democrats involved in this revolving door as are Republicans. So you don't have anything to worry about.

Mr. HILER. What was the sentence that you preceded that with?

Mr. STORY. It was a quote from Mr. Jack Blum's testimony about the dazzling quality of great wealth.

Mr. HILER. Yes.

Mr. STORY. I continued actually from his testimony in which I said the list of some former operatives includes, and then I listed former Ambassadors to the region. It is on page 24 of the testimony. This is on the record. It has been for 2 years but I brought it up again because I think it needs another airing.

Mr. HILER. Who was dazzled by the prospect of a share in such wealth—what did he mean by that?

Mr. STORY. I am not going to mention any names now in case there are repercussions; but I have actually one individual very firmly in mind. Mr. Blum's idea was that having formulated policy people moved from positions of influence where they formulated policy, into positions outside where they benefited from the policies they formulated in the first place.

It is something that supposedly can't happen with the British civil service because there isn't the interaction there is here. It has its great strengths, I don't deny, but it also has obvious potential weaknesses.

If I may move on very quickly—I don't want to drag you through the whole of this—I have dealt with the vexed issue of the underreporting of reserves which we have discussed, or your subcommittee has discussed, in the past.

Essentially this is the question of Saudi Arabia, Kuwait, United Arab Emirates, and Qatar in particular, underreporting or not reporting reserves.

Qatar, which is the least important, earned nearly $20 billion in 1974 to 1980. If you look at the international reserves line in the international financial statistical breakdown, you will find their reserves are said to be $393 million. This is absurd.

Note that the Bundesbank is very uptight about this matter, as well. On page 29 of my testimony I cite a reference to this, taken from the Bundesbank 1980 annual report in which the Bundesbank complains—and it is not the first time, it is the second time that I have identified it in their annual reports—that it is intolerable that the reserves of these wealthy countries should be understated.

Of course, the fact of the matter is that because these countries are not identifying their reserves correctly in their reports to the IMF's objective observers have no means of getting a handle on the overall value of international reserves.

The Bundesbank in its report says specifically:

> The reserve statistics of the IMF do not cover liquid investments by quasi-official institutions or other funds with the character of reserves, which have increased considerably in recent years.
>
> This has become known on the basis of partial data, in particular information on the investment policy of the OPEC countries. The figures published by the IMF therefore give an incomplete picture of the development of international liquidity.
>
> This could lead to an underestimation of the expansion of liquidity caused by the way in which high current account balances are financed.

You have to make due allowance for language used by central banks in their public statements. I spend most of my time trying to read public statements and it is quite clear from this statement, and also from the previous comment, that they are very concerned about the falsification for public consumption of OPEC international reserves figures.

I would also add that the Bundesbank shares my interpretation of how these dollars came to exist in the first place. The Bundesbank recognizes these huge figures have been generated by the linking of external dollar liquidity to the escalating cartelized oil price.

I will now go to the main conclusion of my summary. Having dealt with various gaps in the global figures, including the huge gap in the global trade account—for your information, the world made a loss in trade with itself, $392 billion in 1955 to 1980—the discrepancy in various assessments of the global current account deficit, the question of the gap in the U.S. balance-of-payments deficit, which amounted to $75 billion in 1975 to 1980, and various other discrepancies—I have been through those and the burden of what I say in that section of the presentation is that none of these discrepancies can be addressed or solved without all the discrepancies being solved.

This is something which officials, I think, will have great difficulty in accepting. The working group at the Commerce Department looking into the U.S. balance-of-payments discrepancy has provided, I think, unconvincing explanations for some of the reasons for this discrepancy; but they are not looking, I understand, into such questions as the huge narcotics trade which the Treasury says accounts for something like $60 billion of unreported flows of funds.

Indeed, the Treasury's current investigation into the underground economy, notably the narcotics segment of it in Florida, is said by Treasury officials to be the biggest they have ever undertaken, involving billions and billions of dollars.

As a layman, I have the greatest difficulty in understanding why the Commerce Department thinks it is contributing to the overall sum of human knowledge in seeking to investigate the U.S. balance-of-payments deficit, while omitting reference to the narcotics investigation.

It seems to me that, if I may conclude, all these discrepancies have to be looked at together. There may be links between the discrepancies which are not immediately apparent and I don't think any advance is going to be made until they are all looked at together.

This, of course, greatly complicates your investigations because if you were hoping to try to explain the U.S. balance-of-payments deficit, or to try to explain some of the missing OPEC wealth, and put it into the U.S. balance-of-payments deficit, you have problems because of the narcotics gap—quite apart from anything else.

To summarize; the general conclusion to be derived from this investigation, which touches also upon the military dimension, is that the many uncertainties which surround petroliquidity flows should be sufficient to convince the most determined analysts that attempts to quantify what is happening to OPEC funds, and the size of the investible surplus, are probably a waste of time.

As the petroleum-driven monetary expansion continues; the numbers balloon to colossal proportions; more and more surplus liquidity is siphoned into commissions, the underground economy, corruption and military-industrial transactions; it will make less and less sense to seek to identify what is happening to all this depreciating paper money.

The avalanche of inflationary dollar liquidity has reproduced itself by more than a factor of 10 since George Schultz first rejoiced at the U.S. Government's new freedom to print money and overspend, back in August 1971.

Mr. ROSENTHAL. Following up on that "revolving-door" story you told us about on page 24, do you know where Mr. Schultz is now?

Mr. STORY. No, sir.

Mr. ROSENTHAL. You don't?

Mr. STORY. I ought to.
Mr. ROSENTHAL. If you don't, you don't.
Mr. STORY. But you do.
Mr. ROSENTHAL. I think I do, yes.
Mr. STORY. Perhaps you could tell me afterward.
Mr. ROSENTHAL. Perhaps I will.
[Note.—Mr. Shultz is president of Bechtel Corp., which has contracts with Saudi Arabia.]

Mr. STORY. I have attempted to lock the interpretation into the U.S. Government's permissive deficit financial system and it is significant that the Federal Financing Bank has taken over the funding of the transfer of military equipment to countries which Saudi Arabia is not sponsoring.

That is a sinister development, because the Federal Financing Bank, through its activities pushes up the statutory credit ceiling—contributing to this farcical situation, where several times a year, the Secretary of the Treasury has to go to Congress to ask for an increase in the statutory debt ceiling to take account of commitments which have already been made.

This seems to me to represent part of the problem that you face. Congress seems to have lost control over off-budget spending.

In this connection I am alarmed to note, in the Omnibus Budget Reconciliation Act of 1981 containing the Energy Department's oil price projections, that the Strategic Petroleum Reserve account of the Treasury is an "off-budget" account in that it is excluded specifically from the statutory debt ceiling.

If, on the one hand, you are passing legislation which expands the scope of deficit financing, how on Earth can the administration expect to retain the confidence of the financial markets if it purports to be struggling to reduce them?

Mr. ROSENTHAL. We only have 15 minutes to go and if we can sum this thing up—I want to say this much, that is, I think this is probably one of the most knowledgeable and well prepared and thoughtful statements that I have ever seen in my service on this committee or any other committee. Obviously you have an incredible and vast fund of knowledge.

Do you think the confidentiality agreements that the Treasury entertained with Saudi Arabia and Kuwait are in the best interests of the United States or the world financial community?

Mr. STORY. In the context of what I said before, I am appalled at the collaboration of the United States with a monopoly system. It is corrupt and it leads to bilateral arrangements which cut across the free-trading philosophy of the United States, so on general grounds I am very much opposed to this and I think that the confidentiality is just one dimension of this monopoly.

Mr. ROSENTHAL. Specifically, should the Congress be concerned about it and why?

Mr. STORY. The Congress should be concerned about it for the reason I have given, that it is inconsistent with U.S. promotion of free trade policy.

If you are going to live with monopolies and benefit from the liquidity generation process which results from living with monopolies and accommodating and appeasing monopolies, you cannot on the other hand parade before the international community your adherence to a free-trade system because it is contrary to the principles of free trade.

Therefore, in principle I am opposed to it.

From the point of view of the United States, I can see there are obvious, very severe hazards in any way going for total disclosure.

Mr. ROSENTHAL. Why are there severe hazards?

Mr. STORY. The hazards are that you would have some immediate removal of funds from U.S. banks.

Mr. ROSENTHAL. Do you see that as a serious possibility? The previous witness didn't seem to be too distressed about that.

Mr. STORY. The Treasury is distressed about it. The Treasury sponsored the International Emergency Powers Act specifically to guard against any such possibility. That is the purpose of the act.

Mr. ROSENTHAL. Is the problem getting worse?

Mr. STORY. The bigger the numbers get, the more dangerous this becomes. The numbers are ballooning. As we have already discussed, the numbers will become absolutely colossal over the next 10 years.

I am worried about the business of looking at the figures as they are now. We have to look ahead. We have got into bed with these people, we are stuck with this system, and we can't get out of it. You can't go backward. The liquidity has to come from somewhere. It has to be generated for future use.

The banks are going to need additional liquidity when all these loans go bad. So we can't get out of bed. But it is still an evil system and it is inconsistent with the principles of free trade and economic stability.

Mr. ROSENTHAL. Why can't we get out of bed, as you say?

Mr. STORY. The problem is, how are the banks' bad debts going to be alleviated? Some banks are very close to having overstepped the mark. Governor Wallich will deny this but, on the other hand, he will also indicate to you that the Federal Reserve has no limit to the amount of liquidity which it would, in an emergency, inject into the banking system.

Mr. ROSENTHAL. If you are appalled by the system, should Congress do something about it?

Mr. STORY. Having accommodated and appeased monopoly forces, I am at a loss to see how you can put the clock back. Of course, if nothing goes wrong and we don't have a world war or other upheavals, in 15 or 20 years the energy problem should solve itself provided other alternative sources are brought onstream. The most important of these is hydrogen energy and the inertial confinement process.

If free market forces operate in this area, and replacement sources of petroleum come onstream eventually, the situation may become less worrying in due course.

But as the proliferation of petrodollar liquidity increases and investment interests become more entrenched, I see powerful forces working against the development of alternative energy sources.

Mr. ROSENTHAL. You tend to expand on the question but it is a very pleasant exercise. The question that I raised with the previous witness and one that concerns me where you have governments as investors, as depositors and/or investors as compared to private individuals, there is always the potential for political pull in one direction or another.

If some of these massive investments were subject to political pressures, do you see that as any kind of threat? Do you see any scenario where the U.S. banking system could be damaged?

Mr. STORY. I certainly do. Another dimension of the appeasement of the monopoly is that flows of funds are subject to arbitrary, unpredictable political decisions and whims and that is one of the hazards of this decadent system.

I think perhaps this is a point in which I could insert the question of how does the Soviet Union react to this situation? As I see it, they insert their boot from time to time to divert petrodollars in its direction. You have already mentioned the statement of the Iraqi Finance Minister.

Although the previous witness said this had no effect on the financial markets, it is not the first time this statement was made. In 1980, the Soviets were working on the Arab members of OPEC to persuade them to remove funds from U.S. banks.

This is actually the third statement I have seen on the subject; so the Soviet Union is prodding or probing to see how far it can go.

It is very important to take that seriously. The Soviets are looking at this. They are well aware of the fact that the whole financial pack of cards is fragile and they are just probing.

There is another point I would like to add. Only the other day, at the beginning of September, Qadhafi, who operates sort of as a proxy to the Soviet Union, agreed to pay the Ethiopian Government, another revolutionary and Soviet-dominated regime, $10 million by way of cash—$150 million to pay for Ethiopian arms imports from the Soviet Union, and $100 million to finance the urgent purchase of spare parts for aircraft and tanks; 260 million petrodollars, being diverted into the Soviet International Financial Institutions.

You can hold dollars in Gosbank if you want to. In this connection the U.S. Treasury says $55 billion of petrodollars is placed in less developed countries and in COMECON countries.

I would like to know from the Treasury whether they can give us a breakdown of how much is in COMECON banks. So the Soviet Union is involved in diverting petrodollars.

There is another instance of political diversion of funds on a colossal scale which occurred earlier this year when $9.5 billion was diverted to Iraq from Saudia Arabia and others. The source of this information is various broadcasts, notably some announcements monitored by the BBC in April 1981; and the clue was given when the Kuwait National Assembly agreed to deploy $2.5 billion in favor of Iraq. So there is $9.5 billion which is maybe capable of being monitored but it is being diverted for political purposes. During the fall, Kuwait extended Iraq a further KD 2,000—about $7 billion—partly to finance the purchase of Chinese-made T-54 tanks.

I think this is a serious development.

Mr. ROSENTHAL. Mr. Hiler?

Mr. HILER. I am looking forward to reading the statement.

Mr. ROSENTHAL. Mr. Daub.

Mr. DAUB. I can't compare it to the observation that you made with respect to your testimony, but I would go the other way and say your testimony is extraordinary. And when I look at your projection over the next 9 years, Mr. Story, I understand your assumption is they are going to have an effectively operating cartel for the next 9 years. Am I right?

Mr. STORY. I am making that assumption. I don't necessarily believe it, but that is the assumption.

Mr. DAUB. Why not?

Mr. STORY. Cartels do collapse. I don't think this one will, because I don't think the Western countries will deflate.

Mr. DAUB. It is having, right now, serious internal pricing problems.

Mr. STORY. That is very true.

Mr. DAUB. Assuming they get their act together and they get tighter control prices amongst themselves on their pricing, would you expect they will have greater price cooperation in the next year and a half?

Mr. STORY. You can't tell how these people are going to react. I would think that they will get their act together. There are too many pressures on both sides of the overall arrangement in favor of keeping this gravy train going. I don't think it is going to collapse but that is just an instinctive feeling.

Mr. DAUB. What kind of pressure does the $4 drop in Nigeria put on them?

Mr. STORY. Very severe. The Nigerian Government has now tightened up its exchange control regulations, releasing funds for ordinary trade purposes much less generously than it did in the previous crisis.

Mr. DAUB. Would you speculate they politically read the potential for OPEC to tighten and stabilize their price and that there may be some political tendency on the part of some of the Arab countries to retaliate in the next year for certain things we may be doing, that they see a great market and so they have done that to secure their base for sales in this country?

Mr. STORY. Again, I can't really answer that question. I think that when the chips are down they will stick together. And I think the electoral timetable in so many countries will simply play into their hands: there is no way Mrs. Thatcher can continue with this deflation. Inflation is the order of the day. It is happening in France. It will happen here as well.

Mr. DAUB. Summarize what your definition of appeasement is and what kinds of preferential treatment exists. Just list them.

Mr. STORY. Appeasement started in 1973–74, when the U.S. Treasury and the State Department made the decision that going along with the higher prices had certain advantages.

Mr. DAUB. It did not start in 1971 with the absolute pronouncement that he was glad we were off the gold standard?

Mr. STORY. That is how it actually started.

You cannot go backward and link the 1973, 1974 development with 1971, in the sense that you cannot assume a projection over that period, but what you can say is that it was a normal historical geofinancial development. It fits in perfectly.

Mr. DAUB. Versus reinflation, what if there is any meaningful relationship reestablished with gold prices?

Mr. STORY. I have written separately on the question of the idea of linking the dollar back to gold, and I make formally the following comment.

What is happening is that policymakers are realizing that monetary policy is futile. But they are only discovering it by trial and error, because they do not seem to have understood the reason for the monetary expansion.

One reason the Federal Reserve Board, the Bank of England and the Bundesbank—and all the other central banks—cannot get on top of this, is there are too many distortions in the free market.

Mr. DAUB. Finish your definition of appeasement.

Mr. STORY. In 1973 and 1974, the Treasury and the State Department decided that they would accommodate this new situation, and that they saw very clearly that wealth was going into clearly identified pockets in Saudi Arabia.

Mr. DAUB. So the committee was created?

Mr. STORY. The Joint Economic Commission was established on June 8, 1974, for the purpose of organizing flows and establishing expenditure streams which would benefit the United States.

Mr. DAUB. What other mechanisms?

Mr. STORY. The Joint Military Commission; the secret financial agreement which is no longer a secret agreement; the Joint Economic Commission; and the issue of confidentiality.

Mr. DAUB. Are we doing anything right now currently?

Mr. STORY. Well, it is a constant process, encouraging liquidity into Government securities, into the securities of quasi-Government agencies, Fannie Mae and so on. That has been taking place on a continuing scale all along—the idea being to attract petroleum dollars into the United States.

Mr. DAUB. Why is it unhealthy to encourage the recycling of Arab funds which were, after all, originally American?

Mr. STORY. The funds were—I don't understand why you say they were originally American capital.

Mr. DAUB. After all, they were our creation.

Mr. STORY. The creation took place in response to the monopoly situations which has been described.

Mr. DAUB. How important is it to the investment world? Do you agree with the previous witness, it is somewhere between 200 billion and 300 billion dollars in terms of outside the seven country worldwide investment?

Mr. STORY. The total is roughly the size of the current accumulated OPEC account—some $380 billion.

Mr. DAUB. How important is the investment to the dollars' world value?

Would a short-term disruption because of full disclosure have an effect on that dollar?

Mr. STORY. If there were any sudden withdrawal, unless it was a very minor upheaval, it would have a temporary effect, but this is unknown territory. No one knows this. This is why the Treasury has those precautions in place.

The Treasury speaks with one voice and does something else.

Fred Bergsten was all along saying there would only be temporary interruptions. They sponsored the International Economic Emergency Powers Act, and put in place the International Investment Survey Act. They have taken all those precautions, and they advised the Administration in February 1979, that the International Emergency Economic Powers Act ought to be used; so the Treasury really is just as worried and has been as worried in the past as you have and other people have.

Mr. DAUB. I am done. I want a yes or no now.

If there were some mechanism for full disclosure, I take it you think it will be counterproductive, if not folly, to try to identify and obtain full disclosure. Would this be damaging in any way to the world economy or this country at this time?

Mr. STORY. Immediately, yes; but in the longer term, less so.

Mr. NEAL. The last time this issue came up, and I am sorry I missed all of the witness' testimony, as I recall, the Department of Treasury was very concerned that if, for a number of reasons, we were to require country-by-country listing of investments in this country—some country like Saudi Arabia, for example—it might be destablizing to those Governments, No. 1; and No. 2, that it might well lead to some instability in financial markets, because Governments would, as a result, choose to put their assets elsewhere. Is that a serious concern? Do I recall that correctly? Weren't those two major concerns the last time?

Mr. ROSENTHAL. I think you have stated them accurately.

Mr. STORY. I think we have dealt with this matter. The issue of confidentiality is addressed in my testimony.

Mr. NEAL. Could you speak to it again?

Mr. STORY. It has been a continuing and primary concern of the Treasury to try and prevent the leakage of information about certain investments, and the reason I gave was not perhaps quite the same as the reason the previous witness gave. There is no clear dividing line between private and Government investments.

It was Mr. Bergsten who put his finger on that point. He was a brilliant interpreter of the Treasury's financial goals.

It is very clear what is going on.

Confidentiality is something that they remain concerned about.

Mr. NEAL. Do you agree with that concern? Is it a legitimate concern?

Mr. STORY. Well, no. It is obnoxious in the sense that this is supposed to be a free country, and there should not be bilateral cozy agreements of this sort when such major implications are involved. Now that we have gotten into bed with this cartel, we are irrevocably locked into continuing along this route.

Mr. NEAL. What information do we gain through country-by-country reporting that we don't get by regional reporting? Why is the country-by-country reporting so essential to our remaining a free country?

Mr. STORY. I understand what you are saying. The point is that if you try to inquire of the Treasury how much Saudi Arabia holds in Treasury securities and so on, you cannot establish that information.

I attribute this to the Arab desire, particularly that of Saudi Arabia, not to be clearly identified as a massive holder of wealth.

It is part of the point made by the previous witness; but it is obnoxious on the broader question, because the international dollar system is locked into the appeasement of a cartel. That is the broader point I was trying to make, and you are trying to narrow it.

I would prefer total disclosure, but the Treasury, I suppose, feels that it must maintain certain secrets, and that is one of them. I think it is very unhealthy myself.

Mr. NEAL. I am not sure what we gain by total exposure?

Why do you prefer it?

Mr. STORY. It is impossible for observers of the market to formulate any clear view of what is happening to the flow of funds.

In order to understand what is happening in the international financial system, you have got to know about the flow of funds. But we only have regional reporting now.

Yes. The amount specified by the Treasury for "Other Asia" is a very large sum and is not broken down.

Mr. NEAL. What are we missing by not having it broken down?

Mr. STORY. A clear handle on what proportion of this large amount is held by one very small group.

Mr. NEAL. If we knew that, what would we gain by that knowledge?

Mr. STORY. If the general public or if Congress knew about this, you would know where the hazards lay.

Mr. NEAL. We already know. We know that we are talking about a few Middle Eastern countries that hold a substantial amount of oil wells. We know the source of the wealth and where that wealth is invested, except we just don't know the precise investments by each country any more than we know the precise holdings of individuals in our own society, or in some cases the precise holdings of the corporations or banks, and so on.

This sort of confidentiality is allowed in our free country. We don't go into the personal lives of our people any more than is absolutely necessary.

I am wondering if you are not suggesting a different standard that may be not one that would help us remain freer, but one that might be antithetical. I am not sure. I am raising some question.

You are saying it would be necessary to know and so on, and it might help. Who does it help to know?

Mr. STORY. The key point, my main point is that the United States pursues policy without clear oversight with governments when it is not clear whether these entities are private individuals or governments. There is no democracy in Saudi Arabia. Who are you dealing with? You are dealing with sheiks and people.

Mr. NEAL. Some were with Government.

Mr. STORY. Fred Bergsten says you cannot distinguish between private and Government investment in these countries. That is not a healthy feature, but it is just one feature of the predicament. It is one unhealthy feature of the business of appeasing the cartel. You have got to live with it, and I have said this, that on general principles, it would be best to have total disclosure in the practical world in which we live. We have got to put up to this situation, but you must not object to private investigators such as myself and the previous witness continuing to dig away at this matter, from the point of equity and the point of view of trying to get a handle on what is happening.

Mr. NEAL. Who would gain by this knowledge, you as a private investigator, or our country in our national interest? Would our national interest be served by this?

Mr. STORY. When the figure is ballooned to the extent you are trying to project in this testimony, the figures are going to be much, much larger than they are today. You will have this hearing and go over the same ground in 3 years time and be talking far larger figures.

Mr. NEAL. Right, and we are learning that now. It does seem to me something important to learn.

What would we learn, and what would we gain from a more detailed knowledge of this?

In what way would our national interest be served?

Mr. STORY. What is the point of disclosure at all? Why does the United States disclose more than any other country?

In order for the free market to operate; the whole point of the free market is that it only functions because information is available to it.

We are talking of geofinancial flows which have all sorts of implications; but if you are going to have free disclosure of financial information, you cannot have gaps in that free disclosure; and I apply this just as much to the International Monetary Funds, as to the U.S. Treasury.

Mr. NEAL. As an extension of that, the personal financial statement of all of our citizens ought to be made public knowledge.

Mr. STORY. Suggest to the Treasury they stop wasting public money publishing all the figures that they do.

Mr. NEAL. These are serious questions to me. You are not answering my questions.

I am trying to get at what national interest might be served by this more detailed account? What is it that we would learn that we need to know, and who would it serve?

It is not a practical question, and you would extend that principle, for your purpose, to every private citizen in the world, right?

Mr. STORY. No, I wouldn't, sir. I merely point to the fact that there is an unclear dividing line between the private and public ownership of the funds of certain sensitive Arab Governments, a point mentioned by Mr. Bergsten on numerous occasions. That is the crux of the matter. Are we dealing with Government or private individuals?

Mr. NEAL. Well, all right, let's say that we need to know that. Why do we need to know that? What difference does it make whether we are dealing with the Saudi royal family or the Government of Saudi Arabia, which I understand to be pretty much one in the same?

Mr. STORY. The Treasury does know the answer to those questions, and all that has happened is the Treasury is not divulging this information to the likes of yourself and myself.

Mr. NEAL. Why do we need to know? Maybe I should know something that I don't know?

Mr. STORY. Simply because I feel that international statistics of this kind are indivisible.

You are looking at gaps in the knowledge. You are looking at discrepancies.

Mr. ROSENTHAL. One of the points that the previous witness made in his previous testimony is that individual investments are genuinely motivated for the income and the security and personal appreciation of that individual. They are motiviated more by private financial gain than anything else.

Government investments genuinely are motivated along the same line, but they are also much more subject to political turmoil, change, and political desires.

One of the things we worried about was the Iraqi oil minister urging other Arab governments to withdraw money from the United States. It would be useful to know the extent of investments country by country and to coordinate that with the political situation in each country and their relationship with the Iraqi oil minister in order to know what the risks are.

Individual accounts are less subject to political risk and political turmoil than Government accounts. The advantage to know Government by Government is so each can equally assess the risk state by state and nation by nation. That would be in simple terms the advantages.

Mr. NEAL. Don't we know that?

Mr. ROSENTHAL. The Treasury has refused to make public to any agency of the U.S. Government, including the CIA and the Federal Reserve Board anything other than regional investment. We do not want to know individual investments, individual names, but I think it would be useful for the other agencies of Government and the Congress to know country-by-country investments. That is the only thing we are trying to find out.

I did the best I could in explaining to you why, so that we could interpolate the political risk involved in a different situation and deal with it accordingly. When the Iranian freeze order was put into effect, we had no idea of what the Iranian assets were. These estimates varied somewhere between 6 billion and 12 billion dollars.

In terms of influence, political influence, we want to know the nature of political influence here in the United States. If they buy up all the real estate in Atlanta—Kuwait, for example, buys all the real estate in Atlanta or New York, it would be interesting to know that.

Mr. NEAL. I read a summary of a report indicating that all foreign investment in this country amounted to less than 1 percent.

Mr. ROSENTHAL. I don't know if that is true or not, but we know that these are serious data collection problems and the testimony here today is that OPEC investment is being surrounded in a cloak of secrecy and it amounts to $280 billion, maybe $300 billion worldwide.

Mr. STORY. I think there is one point I would like to add to that, if I may, sir, and that is the denial of detailed breakdowns only applies to the category entitled "Other Asia" by the Treasury. There is this area singled out for preferential treatment.

I think the chairman has given you a better answer than I did.

Mr. ROSENTHAL. I want to correct the record. I said the Treasury would not give it to the CIA.

They did.

They would not give it to the other agencies.

Mr. NEAL. We ought to encourage openness in everything that we do, but we were given some reasons by the Department of Treasury several years ago, and they seemed at the time good reasons. The Treasury argued that the cost of revealing this information country by country would far outweigh the benefits to us during this particular period of time and I am wondering if that still might not be the case.

We did allow ourselves to be subjected to the whims of their very own cartel.

Mr. STORY. To which we are now giving preferential treatment.

Mr. NEAL. Certainly I don't like that, but again, as a practical matter, I still am not convinced that the benefits of this kind of disclosure would outweigh the cost at this particular time.

Mr. STORY. Yes, at this particular time but in 5-years time, the number is going to be much larger.

Mr. ROSENTHAL. Mr. Levitas.

Mr. LEVITAS. I appreciate your letting me continue my participation in this very important discussion.

Let me take Mr. Neal's point and develop it from another angle.

Are there potential adverse consequences that can result from a large investment in the United States by any foreign country in terms of Treasury securities, bank deposits? Are there potentially adverse consequences which can result from that?

Mr. STORY. When flows of funds are incapable of being identified for political reasons, there is a latent hazard.

There was one point which has not been brought out, but in the early days the Treasury tried to sell Saudi Arabia $640 million worth of nonmarketable Treasury securities.

Using a bit of imagination, I assumed that the Treasury did not, or that the Saudi Arabia Monetary Agency would not swallow that more than once; hence the invention of the "add-on" system.

Mr. LEVITAS. If the amount of ownership of U.S. securities, or the size of deposits in the U.S. banking system, or the ownership of real estate can be manipulated by a foreign government which has hostile purposes, is this possible, and could it have an adverse effect in the U.S. economy?

Mr. STORY. As a practical matter, I agreed with the previous witness when he said that, on the whole, the Arabs tend to be responsible investors. The advice which the Kuwait Investment Office obtains in London is the best advice. They are very careful with their investments. They are very sensible with the investments.

If such a political threat were to arise, the Treasury has the International Emergency Economic Powers Act and other resources at its command; so really the answer to your question is that, in the event of an extreme crisis, they would not be able to get away with it because it would be stopped before it happened, I think.

Mr. LEVITAS. The utilization of political decisionmaking is a result of U.S. investments in financial institutions or other corporate investments is one possible consequence of foreign deposits in those institutions, is it not?

Mr. STORY. Yes.

Mr. LEVITAS. I have before me a March 6, 1981, article in "Business International Money Report" which says, "SAMA has repeatedly stressed that it will not lend to companies that are on the official Arab boycott list issued in Damascus. Companies find themselves on the list if they are considered to have done business with Israel or to have 'aided Zionism.' "

Mr. STORY. That is an example of the perverse and unacceptable influence of the cartel, its political consequences.

Mr. LEVITAS. There are others.

Now, it would be important, it seems to me, in answer to the question that Mr. Neal put forth, for us to know specifically which countries, foreign countries, are in such a position to have that influence, not on a regional basis, because policy is not always regionally developed. It is developed by discrete entities known as State organizations pursuing their own national policies, isn't that correct?

Mr. STORY. Correct.

Mr. LEVITAS. I want to know what that policy is from that particular source, the only way I can find that out is to find out the extent of deposits or ownership by that Nation pursuing its particular policy.

Mr. STORY. That is why we need to subdivide the information. That is another reason.

Mr. LEVITAS. Now, you make the statement repeatedly that the U.S. dollar is locked into the cartel.

Now, we are locked into OPEC beyond the situation that has evolved over the last 8 years.

Isn't it also true, that cartel is locked into the U.S. dollar?

Mr. STORY. It is true but that begs the question. There is also the other side to the coin, but it does not undermine the truth of the first part of your statement.

Mr. LEVITAS. I am not questioning the truth of that but also suggesting that the flip side of the coin is also true.

Let me see if I can illustrate that in another way. We keep hearing from the administration and reading that one of the reasons Congress ought to approve the AWAC sale is because of the friendly oil policies of the Saudi Arabia Government.

I am not going to get into that business.

It seems to me the oil policies of the Saudi Arabia Government and in turn what OPEC does, because to a large extent they are one in the same, it seems to me those policies are being pursued in Saudi Arabia's interest, both with respect to its production and pricing and what it means in the long term forcing the United States and the West into creating alternative energy sources and becoming less dependent on OPEC in the long run and with the vast billions of dollars invested in effect in the U.S. dollar, it would be suicidal to quote the Sheikh Yamani, it would be suicidal for them to pursue any other policy. That means their interest, not mine.

Mr. STORY. That may or may not be true, but it is a rationalization after the event. He is very good at rationalizing.

Mr. LEVITAS. Sheikh Yamani has said on several occasions that the policy which is being pursued by his Government in their oil production and pricing policy which is being pursued in terms of their own national interest, and that they believe that a production and pricing policy which would require the Western industrialized nations to be in a position to purchase less and develop alternative energies would work against them in the long run. Either they produce it now or they are going to be draining it in 10 to 15 years. That is in a sense what he has said on several occasions.

Mr. STORY. I also look at Sheikh Yamani's statements very carefully. He is also chairman of the OPEC Long-Term Strategy Committee. Last year, I published an analysis of the draft of that text in International Currency Review which shows that the purpose of the Long-Term Strategy Committee is, in fact, to continue to institutionalize the fleecing of the rest of the world. So what Sheikh Yamani says or may not say is not as important as what he actually does. He is chairman of that Long-Term Strategy Committee and that committee has a very clear objective which is to insure that the present bonanza continues at the expense of other segments of humanity.

It is absolutely obnoxious.

Mr. LEVITAS. Even accepting that as a correct statement, I do not challenge it for the point I am trying to develop. The Saudi Arab policy on production and pricing is done on a short-term and a long-term basis to further the national interests of Saudi Arabia as perceived by Sheikh Yamani and the others who are making those decisions and for no other reasons, whether that is fleecing the West, or maximizing their ability to exploit their resources, the fact is that it is in pursuit of Saudi national interest.

Mr. STORY. Yes, their freedom of maneuver is circumscribed because of their financial, military and other links with the West and particularly the United States. There is a community of interest, but that is the consequence of this bilateral policy.

I am not saying the policy of the Treasury has not been successful. It is antifree trade, and it is not a healthy situation, but it is a situation into which we are now locked as a result of the decisions taken in 1973 and 1974.

Mr. LEVITAS. I appreciate your very enlightening testimony today. I come out on the other side of the question than Mr. Neal does, because I can see some need for the United States to know whether Saudi Arabia or the Soviet Union are heavily investing in U.S. financial markets and other corporate or business interests in this country or real estate which can have political or economic consequences to this country in many ways, and I think that at least those agencies of Government such as the Congress should have that information in formulating our policies.

Mr. NEAL. The gentleman cannot say that I come out on a different side of the issue, because I have not stated what side I am on. I am asking questions. I am pointing out that the Department of Treasury urged us a couple of years ago to move cautiously in this area in our own national interest.

We ought to hear their argument, is what I am saying. I have not formed a position. That is the purpose of holding hearings.

There very well may be some cost involved in this that we have not fully considered, but I have not formed a firm position on it.

I appreciate your yielding.

The witness began a few minutes ago to say something about his thoughts on gold, and I wonder if he could pursue those just for a few minutes. I am on this Gold Commission recently established, and I am trying to come to some better understanding.

Mr. STORY. My interpretation of the gold pressure is really that it represents a potential admission of failure by monetarists who realize they cannot control the expansion of liquidity.

If only you could tie the dollar to gold, you would not be able to print it; but in fact, this is a misconception, because we are now 10 financially innovative years down the road. The complexity of the financial market is such that there is no possibility, in my view, of curbing the expansion of liquidity because liquidity expands to meet requirements. The expansion of liquidity occurs autonomously. If you walk into a bank and you get a loan, the bank has extended you one more loan than it would have done if you had not walked into the bank in the first place.

What makes me suspicious about this gold suggestion is that, when it comes down to it, you cannot actually do that 100 percent; and if you have got a movable base, it is a waste of time, because it simply means you shift the base when the pressures get so great that they cannot be accommodated.

Actually it is going to produce no solutions to the problem.

Mr. NEAL. I generally agree with you, it is another quick financial scheme, I think, but sort of like the voodoo economics.

It sounds real good in a campaign, but as a practical matter, I don't think it would be of great value.

Back to one other point in your testimony. You said we were 10 years down the road concerning gold, and we are a number of years down the road with this Treasury policy, you indicated that.

Are you recommending now that we change direction, or are you saying that since we are so far down the road, that we ought to stick with the road we have pursued?

Mr. STORY. Earlier in discussions I said that we are effectively locked into this situation, and that you just cannot reverse back now. You are stuck with it.

Mr. NEAL. You are saying since we are locked into it, we should not then begin country-by-country reporting?

Mr. STORY. As a matter of principle, it is obnoxious that there should be certain countries which enjoy special reporting privileges. It is not just the U.S. Treasury that is doing this. The United Kingdom Treasury is doing it as well. Schedule 16 of the 1981 Finance Act contains provisions which can be interpreted as discriminating in favor of large OPEC holders. It is an infectious disease, this appeasement process; but once you start appeasement, you cannot, unless there is a calamity, go back.

Mr. NEAL. You are not recommending we go back to country-by-country reporting.

Mr. STORY. Well, the Treasury has resisted this, and as you correctly say, the Treasury has given convincing national reasons for withholding this information, and on the basis of the facts we face, if I were a policymaker in the Treasury, I would certainly advise the same thing, that there are these very sensitive considerations, and this information cannot be divulged as a practical matter. As a matter of principle, it is highly unacceptable.

Mr. NEAL. You cleared this to make sure, if you were in the Department of Treasury now making these decisions, you would not go back, once we started down the road, to country-by-country reporting or engage in country-by-country reporting?

Mr. STORY. Well the Treasury does engage in country-by-country reporting. The Treasury simply discriminates in connection with certain countries.

Mr. NEAL. Would you continue this discrimination or not?

Mr. STORY. As a practical matter, I am afraid I probably would, but as a matter of principle, I would object to what I was doing.

Mr. NEAL. I understand.

I don't like it as a matter of principle either. There is a practical question involved.

Mr. LEVITAS. Are you finished?

On behalf of Mr. Rosenthal, who had to leave a few minutes ago, and the other members of the subcommitee, I thank you very much. Mr. Story, thank you for your participation. I think you have heard from a number of members of the subcommittee how challenging your testimony has been and how comprehensive it has been, and it will assist the subcommittee in pursuing this important investigation and oversight function that we are now engaged in.

Thank you very much.

This is the last witness for the day.

The subcommittee will reconvene tomorrow morning, September 23, at 10 o'clock in the same committee room. The subcommittee stands adjourned.

[Mr. Story's prepared statement follows:]

PETROLIQUIDITY AND THE US TREASURY'S INTERNATIONAL FINANCIAL POLICY

PRESENTATION BY

CHRISTOPHER STORY, EDITOR AND PUBLISHER OF INTERNATIONAL CURRENCY REVIEW AND ASSOCIATED PUBLICATIONS*, LONDON, ENGLAND, BEFORE THE COMMERCE, CONSUMER AND MONETARY AFFAIRS SUBCOMMITTEE OF THE COMMITTEE ON GOVERNMENT OPERATIONS, HOUSE OF REPRESENTATIVES,

22 SEPTEMBER 1981

With the passage of time, it has become progressively harder to recall the historical circumstances which led to the global inflation with which we are now so familiar. As a result, there is a danger that we are coming to accept as normal an economic environment which has, in fact, been permanently disoriented by the appeasement of monopoly forces.

In order to appreciate why today's economic managers face such intractable problems, important linkages between monetary expansion and inflation must be understood. Specifically, in any market which is distorted by monopolies, the supply of liquidity expands to finance the higher prices set by the monopolies. Advocates of 'kindergarten monetarism'[1] make the fatal mistake of assuming essentially 'pure' markets in which supply and demand forces operate; whereas in reality, free markets have been widely distorted by monopoly forces.

The deliberate appeasement of the OPEC cartel by the West[2] - led by the United States and supported by Britain, in the teeth of initial but ultimately

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futile opposition from the European powers - awarded the privilege of setting the world oil price structure to an unstable group of commodity manipulators, to the detriment of international stability. The intentions of this group have been clearly formulated by the OPEC Long-Term Strategy Committee[3], and involve a determination to continue fleecing the world without proper regard for the welfare of any section of humanity other than that of the élite segments of a small, relatively homogeneous section of humanity. I have thoroughly demolished the pretensions of this diabolical scheme, which has successfully hoodwinked every journalist who has written about it, in another forum[4].

The falsification of the oil price structure (see Table 1) was at once accompanied, through the linkage mentioned, by the spontaneous creation of liquidity to finance the higher oil prices. True, existing wealth was transferred to pay for the much higher oil bills - with untidily deflationary implications for the real productive economy, and subsequently devastating consequences for employment. But the falsified oil price increases were far too steep to be accommodated simply by the transfer of existing 'real' wealth; and, as always happens when monopolies distort the prices of key commodities, the central banks simply 'validated' demands for the much greater volume of

End-period	Petroleum price[1]	% change[2]	Consumer prices[3]	US discount rate[4]
1955	1.93	-	0.5	2.50
1960	1.50	- 22.3	1.8	3.00
1965	1.33	- 11.3	2.8	4.50
1966	1.33	nil	3.4	4.50
1967	1.33	nil	2.9	4.50
1968	1.30	- 2.3	3.9	5.50
1969	1.28	- 1.5	4.8	6.00
1970	1.30	+ 1.6	5.6	5.50
1971	1.65	+ 26.9	5.1	4.50
1972	1.90	+ 15.2	4.5	4.50
1973	2.70	+ 42.1	7.5	7.50
1974	9.76	+261.5	13.1	7.75
1975	10.72	+ 12.4	10.8	6.00
1976	11.51	+ 7.4	7.8	5.25
1977	12.40	+ 7.7	8.4	6.00
1978	12.70	+ 2.4	7.2	9.50
1979	16.97	+ 33.6	9.2	12.00
1980	28.67	+ 68.9	11.9	13.00
1981	32.00[5]	+ 11.6[5]	9.8[5]	14.00[6]

Table 1: Selected economic indicators, 1955-81. Notes: [1]Ex-Ras Tanura, Saudi Arabia, US$ per barrel; [2]Percentage change in petroleum price by comparison with preceding entry; [3]Calculated from IMF indices of industrialised country consumer price changes, percentage changes over year-earlier data; [4]% per annum; [5]Figures for April 1981; [6]Data for May 1981.

Source: Derived from International Monetary Fund data.

liquidity which was now needed to pay for imported oil.

In practice, of course, this is an over-simplification of what happened. It was not simply that the Western banking system responded - as all commercial banks must, and central banks of last resort must - to the abundant new loan demand which exploded following the oil price escalation; private corporations, shopkeepers, businessmen and public sector monopolies reacted in similar fashion. Noting that the price of the key consumption commodity (petroleum) had sky-rocketed, all centres of economic activity sought, by every means possible, to increase their access to liquidity. The general instinct for economic survival, fuelled by heightened inflationary expectations nurtured by the spectacle of the cartel's 'success', contributed very materially to the concomitant expansion of the global money supply.

No-one, of course, had heard of monetarism before the collapse of the post-war Bretton Woods régime. What 'kindergarten monetarism' does, essentially, is to rationalise frustrations derived from the empirical observation that there appears to be a link between inflation and monetary expansion[5], by claiming that if the supply of money is curbed, then inflationary pressures will be subdued accordingly. This, of course, overlooks the fact that in monopoly-distorted markets, the supply of money expands autonomously to finance the falsified prices set by monopolies. Monetarism, as interpreted by politicians on both sides of the Atlantic, is thus out of touch with the monopoly-ridden economic reality of today.

* * *

US TREASURY REJOICED AT ITS NEW FREE-SPENDING OPPORTUNITIES

In August 1971, George Schultz, President Nixon's Treasury Secretary, announced that the momentous decision to sever the dollar's last remaining link with gold had 'freed us to follow the domestic policies that we feel are the important ones'. This is persuasive evidence that the US Treasury saw enticing advantages in a monetary régime in which no fixed impediment stood in the way of theoretically unlimited monetary creation. The Federal Reserve's current obsession with the manipulation of unbelievably complex monetary targetry[6] can be interpreted as an attempt by helpless monetary managers to rationalise their need for a cohesive system whereby they can persuade themselves that they are somehow 'controlling' the expansion of liquidity.

But whatever the Federal Reserve may propose, it is clear that the Treasury disposes. George Schultz may not have foreseen the full implications of what he was saying, even for domestic policy: the Federal Financing Bank and its associated 'off-budget' deficit-financing abuses would have been unthinkable prior to the 'freeing' of the dollar from gold. The Federal Financing Bank Act of 1973 was sponsored by the Treasury; and Mr Paul Volcker, now ironically Chairman of the Federal Reserve Board which is trying in vain to dampen the inflationary consequences of the Federal Government's permissive deficit-spending, testified persuasively before Congressional Committees in favour of its establishment[8].

As for US international financial policy, the 'freeing' of the dollar in August 1971 opened up fabulous new opportunities based on the expansion of the global stock of dollar liquidity. Perversely, however, the dollar's new 'freedom to proliferate' became linked to the falsification of the price structure of the world's most essential commodity: petroleum.

Insufficient research has been carried out for it to have been definitively established how far the Executive Branch - in the shape of the Treasury Department and the Department of State - were involved, directly and indirectly, in the process of appeasement and accommodation of the OPEC cartel and international oil interests during the early and mid-1970s. Worrying reports about the behaviour of certain key officials, together with persistent concerns about the frequency with which officials have since resorted to the use of the so-called 'revolving door'[9] to secure lucrative positions and contracts after periods of government service, remain to be allayed. What is indisputable, and of profound geofinancial consequence, is that in 1975 the OPEC cartel arbitrarily refused to accept settlement of its oil bills in any currency other than dollars.

In order to disguise the true implications of this remarkable coup, the cartel's by now powerful public relations machine succeeded in confusing the media by not discouraging speculation concerning a possible scheme involving the use of a 'currency basket', which OPEC threatened to employ as a means of preserving the value of its dollar-denominated assets. Behind this smokescreen, however, oil payments were now being settled exclusively in dollars.

Sterling, it will be recalled, collapsed. It did so primarily because demand for the British currency, previously in widespread use as a currency of petroleum remittance, ceased overnight. The Labour Government in London picked up the wrong end of the stick, embracing the fallacy that sterling's weakness had, in fact, been due to the 'overhang' of sterling holdings overseas. By contrast, the dollar became conspicuously less unstable.

The primary reason for the dollar's renewed lease of life was that demand for dollars to meet oil payment obligations had now become a routine feature of foreign exchange market transactions. In other words, the dollar was constantly 'buoyed up' on the exchange market by non-stop transactions demand attributable to the need for foreign countries to meet their dollar-denominated oil bills.

It can be argued that, in requiring payment to be made exclusively in dollars, the cartel was demonstrating a sense of 'responsibility'. If other countries had been permitted to pay for their imported oil by issuing their own currency, like the United States, and the OPEC countries had been willing to accept such non-dollar remittances, demand for OPEC oil would probably have known no bounds; and the price of the cartel's petroleum would have risen even further[10].

On the other hand, it can also be perceived that the United States benefited enormously from this convenient arrangement. For not only was the dollar now more supreme than ever, through its 'watertight' link to the most critical consumption commodity, which remained in heavy demand despite its falsified price structure - but its external value, which would otherwise become vulnerable as the external dollar overhang grew, would be maintained indefinitely by the foreign exchange market impact of constant 'transactions' demand for dollars from non-dollar countries.

* * *

TREASURY UNDERSTOOD AND EXPLOITED THE OIL-DOLLAR LINK

That US officials clearly understood the global monetary implications of the dollar-petroleum proliferation mechanism is beyond doubt. As President of the Federal Reserve Bank of New York, Mr Volcker wrote to the General Accounting Office (GAO) on 13 April 1979, commenting favourably on a GAO report which, echoing the Treasury's standard line, had concluded that even a massive OPEC sale of US securities or withdrawal of deposits from US banks would probably have a minimal impact on the US financial system[11]:

'We agree with the general thrust of the report that (OPEC financial holdings) do not themselves present a significant potential for affecting adversely the US financial system or economy', he wrote. 'Our financial instruments and markets have coped well with the massive international flow of funds that have developed in recent years in the wake of major increases in energy prices and other dislocations in the world economy'. The implication of this comment is self-evident, if tautological: *the massive surges in the growing international flow of funds had been directly generated by, and associated with, the cartelisation of the oil market, the consequent falsification of oil prices, and the autonomous manufacture of liquidity to finance a much higher oil price structure.*

On the previous occasion when I testified before a Subcommittee[12], in September 1978, I forecast a further massive escalation of oil prices. Immediately following me, Professor Robert Aliber derided any such prospect - anticipating, on the contrary, that all OPEC countries would be running balance-of-payments deficits by the fall of 1979. It is now, of course, fashionable to believe that the cartel is in such severe difficulties that significant potential exists for further erosion of the oil price in dollar terms.

It might be thought, too, that the strength of the dollar - underpinned by a combination of the mentioned 'transactions' factor, the much higher dollar interest rate fluctuation level reflecting a risk premium which has been the unavoidable consequence of the Fed's new monetary control procedures, recent and prospective legislation to liberalise interest rates further, and the continuing permissive deficit-spending habits of the Federal sector[13] - would make OPEC countries careless about the cartel's cohesion, and even responsive to the pleas of non-dollar countries which are having to pay up to 46% more for their imported oil, due to currency changes, than was the case last October. My own instinct tells me, however, that reflation in the West (however disguised for political face-saving purposes) will buttress the cartel's false price structure in the nick of time, and that the petroleum price projections of the Department of Energy, summarised in Table 2, should be considered a reliable, even conservative, projection of dollar-denominated oil prices up to 1989[14].

Of course, if the cartel were actually to fall apart under the pressure of the economic realities it now faces, the outlook for the international financial system and world economy would be extremely grim - much more so, in my view, than if the present petroleum-monetary inflation were to persist, as the Energy Department clearly believes it will. Deflation is intolerable; inflation can be tolerated. If forced to choose between these alternatives,

Calendar year	Current dollars
1980	28.98
1981	34.50
1982	39.34
1983	42.55
1984	46.55
1985	50.59
1986	54.93
1987	59.64
1988	64.74
1989	70.30

Table 2: The US Department of Energy's oil price assumptions in respect of oil to be purchased for the Strategic Petroleum Reserve: fiscal year 1981 Congressional budget request.

Source: US Department of Energy.

most of us would have a clear preference for inflation. What makes the spectre of an oil price standstill or decline particularly alarming is the associated prospect that fresh supplies of petroliquidity would no longer be forthcoming to replace money used as a base for on-lending to chronically delinquent sovereign borrowers by international bankers who have forgotten the wisdom contained in the mediaeval proverb: 'Lend not to him who is mightier than thou; or, if thou lendest, look upon thy loan as lost'[15]. Recently, the Brazilian Finance Minister, Dr Delfim Netto, was criticised for having allowed Brazil to become too dependent on the rest of the world, which it owes $64 billion. In response to this accusation, Dr Netto quipped that the rest of the world's dependence on Brazil had also increased. This, of course, was an echo of the well-known aphorism that if you owe the bank $1 million, you are in a weak position; but if you owe the bank $1 billion, the bank is in a weak position.

Matters have now reached such a pass that certain notoriously delinquent sovereign euromarket borrowers are milking the international banking system for all they can extract, on the presumption that the system needs their 'good behaviour' just as much as they urgently need the money. Having been geared-up by the expansion of the global money supply to finance much higher petroleum prices, the size of the gross euromarket - at nearly $1600 billion - is now exactly ten times greater than it was when President Nixon severed the dollar's last remaining link with gold in 1971. The present arrangements cannot survive without being constantly replenished with new petrodeposits.

* * *

SAUDI ARABIA CAN EXPECT TO EARN $1,690 BILLION IN 1981-89

But if, in practice, the Department of Energy's oil price projections turn out to be reasonably accurate, it is worth considering what Saudi Arabia would earn from the export of petroleum during the years ahead[16]. Assuming, for the sake of this analysis only, that the Saudis were to export all their production - that is, an average of 10 million barrels per day - over the entire period, it can be calculated that the Kingdom stands to receive $1,690,463,000,000 ($1,691 billion) during the years 1981-89 inclusive. Put another way, importers of Saudi Arabian crude will be called upon to spend roughly the total current value of the gross euromarket (see Table 3) in order to acquire Saudi petroleum at this constant rate, over the period.

Such colossal accruals would dwarf the $369,855 million which Saudi Arabia earned, exclusive of investment interest, between 1955 and 1980 (see Table 4). Of that total, incidentally, only $17,074 million was earned during the first 15 years of the period - with $12,510 million being earned from oil imports in the 1960s.

Saudi Arabia's earnings from sales of exported petroleum during the 1970s amounted to $357,345 million - an increase of 2,857% by comparison with the country's earnings from such sales during the preceding decade. By contrast, if the Saudi Arabian régime were actually to earn the projected $1,690 billion in 1981-89, this would represent an increase over those nine years of 'only' 473%, by comparison with the country's export earnings during the 1970s.

Over the whole of the present decade, such earnings will equate to about

Item	1971	1972	1973	1974	1975	1976	1977	1978	1979	Sep 1980	Dec 1980	Mar 1981[1]
Gross euromarket size:	150	205	310	390	480	590	725	930	1,190	1,365	1,470	1,540
Liabilities to non-banks	30	35	55	75	80	100	125	170	230	270	270	n.a.
Liabilities to central banks	15	25	40	60	70	85	110	120	155	170	180	n.a.
Liabilities to other banks	105	145	215	255	330	405	490	640	805	925	1,020	n.a.
Net euromarket size:	85	110	160	215	250	310	390	485	600	700	735	770
Claims on non-banks	35	45	65	100	115	150	195	245	295	355	355	n.a.
Claims on central banks and on banks outside market area	35	45	75	95	115	135	155	195	245	275	295	n.a.
Conversions of eurofunds into domestic currencies by banks in market area	15	20	20	20	20	25	30	45	60	70	75	n.a.
Euro-dollars as % of gross liabilities of all eurocurrencies	76	78	73	77	78	79	76	74	72	73	76	n.a.

Table 3: The size of the eurocurrency market, based on foreign currency liabilities and claims of banks in major European countries, the Bahamas, Bahrain, Cayman Islands, Panama, Canada, Japan, Hong Kong and Singapore; in billions of dollars (rounded to nearest $5 billion), at end of period. Note: [1] Provisional.
Source: Morgan Guaranty Trust Company.

Year	Saudi Arabian exports	Saudi Arabian imports	Saudi trade balance
1955	621	224	+ 397
1956	610	256	+ 354
1957	600	264	+ 336
1958	885	245	+ 640
1959	957	232	+ 725
1960	891	213	+ 678
1961	956	238	+ 718
1962	1,067	280	+ 767
1963	1,120	291	+ 829
1964	1,184	358	+ 826
1965	1,396	460	+ 936
1966	1,649	538	+ 1,111
1967	1,780	516	+ 1,264
1968	1,758	496	+ 1,262
1969	1,600	667	+ 933
1970	2,357	629	+ 1,728
1971	3,450	733	+ 2,717
1972	4,517	1,008	+ 3,509
1973	7,630	1,845	+ 5,785
1974	31,242	3,763	+ 27,479[2]
1975	28,005	6,561	+ 21,444
1976	36,436	11,099	+ 25,337
1977	41,207	15,600	+ 25,607
1978	37,866	20,361	+ 17,505
1979	57,620	24,000	+ 33,620
1980	102,471	28,500	+ 73,971
1981	116,696[1]	n.a.	n.a.
1955-80:	369,855	119,377	+250,478

Table 4: Saudi Arabia's merchandise trade performance, 1955-80, in millions of US dollars. Notes: [1]Based on the first quarter's data; [2]From 1974, data derived from IMF Direction of Trade.

568% more than Saudi Arabia earned from oil exports in the preceding ten years. But total Saudi earnings from exported oil will be roughly 16,211% higher during the 1980s, on the basis of the Energy Department's oil price projections, than in the 1960s. And assuming, too, that Saudi Arabia's potential trade balance during 1981-89 remains at about 68% of total sales - the average level recorded during 1955-80 - it can be calculated that the Kingdom will earn about $1,150 billion on trade account alone (before transfers and expenditure on services) during those years.

Similarly alarming projections can be made for Kuwait (see Table 5), which received $113,057 million from export sales in 1955-80, on which it earned a trade balance of $78,282 million. During the 1950s and 1960s, Kuwait was level-pegging with Saudi Arabia - earning petroleum export revenues of $17,663 million in 1955-70, of which $12,890 million was earned during the decade of the 1960s.

But in the following ten years, Kuwait earned $95,394 million from oil exports - an increase of 540% over the previous decade's foreign trade accruals. The origins of the well-known antagonism between Kuwait and Saudi Arabia may, of course, be detected from these crude data: suddenly, in the 1970s, Saudi Arabia becomes a far larger earner of revenues from exported oil, than Kuwait.

Table 6 shows that 10 OPEC countries - Algeria, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Saudi Arabia, the United Arab Emirates and Venezuela - earned nearly $1,400 billion from exported oil in 1955-80, on which they recorded a trade surplus of $685 billion. Since their purchases of goods from other countries during this period amounted to some $703 billion (not allowing for purchases from other OPEC countries), these states extracted wealth from the rest of the world equivalent to almost the total value of their goods purchases. As I have pointed out elsewhere[17], the failure of the ten oil-producing countries to spend $685 billion on goods, even though a proportion of this total was spent on services, contributed materially to

Year	Kuwaiti exports	Kuwaiti imports	Kuwaiti trade balance
1955	651	82	+ 569
1956	675	100	+ 575
1957	735	146	+ 589
1958	930	183	+ 747
1959	830	225	+ 605
1960	962	210	+ 752
1961	962	217	+ 745
1962	1,077	248	+ 829
1963	1,136	281	+ 855
1964	1,251	280	+ 971
1965	1,284	328	+ 956
1966	1,342	402	+ 940
1967	1,291	516	+ 775
1968	1,381	531	+ 850
1969	1,473	564	+ 909
1970	1,693	544	+ 1,149
1971	2,271	567	+ 1,704
1972	2,558	693	+ 1,865
1973	3,324	916	+ 2,408
1974	10,330	1,554	+ 8,776[2]
1975	8,644	2,180	+ 6,464
1976	9,830	3,480	+ 6,350
1977	9,793	4,330	+ 5,463
1978	10,414	4,691	+ 5,723
1979	18,259	5,308	+12,951
1980	19,961	6,199	+13,762
1981	23,502[1]	n.a.	n.a.
1955-80:	113,057	34,775	+78,282

Table 5: Kuwait's foreign trade results, 1955-80, in millions of US dollars.
Notes: [1]Based on first quarter's data; [2]From 1974, data derived from IMF Direction of Trade.

Year	Exports	Imports	Trade balance
1955	5,894	3,820	+ 2,074
1956	6,615	4,558	+ 2,057
1957	6,909	5,639	+ 1,270
1958	7,059	5,164	+ 1,895
1959	7,046	5,340	+ 1,706
1960	7,316	5,377	+ 1,939
1961	7,289	5,360	+ 1,929
1962	7,469	4,559	+ 2,910
1963	8,662	4,648	+ 4,014
1964	9,695	5,594	+ 4,101
1965	10,446	6,251	+ 4,195
1966	11,192	6,319	+ 4,873
1967	12,144	6,711	+ 5,433
1968	13,273	7,474	+ 5,799
1969	14,595	8,697	+ 5,898
1970	17,296	9,693	+ 7,603
1971	21,893	11,328	+ 10,565
1972	24,501	13,733	+ 10,768
1973	38,698	19,907	+ 18,791
1974	117,794	33,857	+ 83,937
1975	109,444	53,868	+ 55,576
1976	133,081	62,855	+ 70,226
1977	145,632	84,486	+ 61,146
1978	141,850	94,880	+ 46,970
1979	208,040	101,590	+106,450
1980	293,360	130,810	+162,550
1981[1]	300,920	n.a.	n.a.
1955-80:	1,387,193	702,518	+684,675

Table 6: Merchandise trade performance of 10 OPEC countries, in millions of dollars, 1955-80. Note: [1]Based on first quarter's data.

undermining the cohesion of productive economies - since employment is mainly provided by producers of goods, rather than of services. This consideration is consistent with the facts that the additional hard currency needed to finance the falsified higher oil price structure was derived, in part, from the diversion of existing spending power, but mainly from the creation of money by the central banks.

Looking at the trade earnings of the ten OPEC countries as a whole provides the perspective necessary for any proper understanding of the global oil-price induced inflation which has overtaken the international economy in recent years. During the first five years of the period covered in Table 6, the group earned $41 billion from export sales of oil. In the following ten years, they received $112 billion - bringing the total earned in 1955-70 to $153 billion. But in the subsequent decade, aggregate earnings amounted to $1,234 billion - an increase of 1,001% - vastly in excess of reported global inflation over the period, which the IMF puts at 116.5%[18, 19]. In 1974-75, the re-invention of the banking concept of recycling dampened fears that the damage already inflicted by the falsification of oil prices might prove fatal for the survival of the international financial and trading systems. But the bankers who promoted this comforting concept, notably Mr Volcker himself, omitted to draw attention to the fact that the placement of huge sums of liquidity on deposit is no substitute for the circulation of that liquidity to finance productive enterprise, which creates real wealth - thereby improving living standards and enhancing the strength of the real economy. The money deposited with the Western banking system - and, in order to avoid placements with Jewish banks, with Arab institutions and banking networks specially created for the purpose - has been used, in part, to provide the basis for continuous on-lending to countries the external economies of which were thrown into disarray as a direct consequence of the oil price escalations. This banking bonanza has benefited nobody but the banking community; and even international bankers are nowadays asking themselves whether, and for how long, lending to chronic delinquent sovereign borrowers can 'safely' continue.

* * *

US GOVERNMENT STANDS READY TO FREEZE SAUDI FINANCIAL HOLDINGS...
These investigations prompt two nagging basic questions: where did all those dollars come from; and what has happened to them? The first of these elementary questions has already been answered: these dollars did not exist before the cartelisation of the oil price. They were effectively created by the international commercial and national central banking systems, to finance the higher oil price structure.

Answering the second question - what has happened to all these new dollars, and what is happening to them now - requires patient detective work. To the extent that answers cannot easily be prised out of secretive officials and bankers, they depend on the efforts of independent researchers who - no doubt annoyingly from the point of view of officials - persist in seeking answers to these awkward issues.

The complacency with which officials have affronted repeated Congressional attempts to address these matters reflects, of course, their familiarity with the continuous dollar-creation mechanism that has been described. Because they have all along understood so clearly the answer to the first question - where have the dollars come from? - they have never been as exercised as Congress over the need to seek convincing or illuminating answers to the second question. The former Assistant Treasury Secretary for International Affairs, C Fred Bergsten, was particularly adamant in testimony[20] and correspondence that the abrupt removal of 'OPEC deposits from the US... would create problems, but not of a catastrophic nature'[21]. The Treasury's calm approach to this issue, for public consumption, did not, of course, stand in the way of its better judgement: drastic precautions against the possibility of a sudden, disruptive withdrawal of Iranian financial assets from US financial institutions were the subject of serious official analysis and positive advice as early as February 1979[22]. But publicly, the Treasury went out of its way to provide reassurance that the possibility of sudden OPEC withdrawals was not a cause for concern:

'As a practical matter', wrote Mr W Michael Blumenthal, Treasury Secretary, in response to written questions raised by Congressman John Cavanaugh[23], 'deposits withdrawn from a bank or banks must either be redeposited directly in another bank(s) or used to purchase goods, services or investments, with the proceeds of these sales being placed in the banking system in the absence of monetary policies designed to sterilize such funds'.

But to be on the safe side, the Treasury had secured, in the International Emergency Economic Powers Act[24] approved by Congress in December 1977, severe executive powers which could be deployed with the minimum of Congressional consultation to freeze or seize the assets of foreigners at the apparent whim of the President. Treasury Secretary G William Miller must have had a hard time persuading his Saudi friends, in the course of that whirlwind trip to the Middle East shortly after President Carter had invoked this legislation against Iranian assets, that circumstances could not be envisaged under which the International Emergency Economic Powers Act might be deployed against the assets of the oil-rich Arab states themselves - especially since the Saudis had demonstrated, by not renewing placements of Treasury securities in the third quarter of 1978, that they were quite capable of undermining the dollar in pursuit of their own interests, should they choose to do so. In the light of this, Mr Bergsten was perhaps less than frank when he wrote on 19 April 1979 to the General Accounting Office that 'we recognize, of course, that a sudden, massive attempt, whether by OPEC countries, by other foreigners or by Americans, to convert into other currencies dollar assets held in the US or abroad, could adversely affect the dollar exchange rate'[25]. That was precisely what had happened in the fall of 1978; it was the background against which President Carter was compelled to introduce his famous 'package' of 1 November that year.

Moreover the record of earlier hearings conducted by this Subcommittee contains a secret note dated June 1978 and headed 'Saudi Arabian foreign investment', which speculated darkly about the possibility that the US Administration might, under certain circumstances, invoke the President's powers under the International Emergency Economic Powers Act of 1977 to freeze Saudi dollar assets[26]. Specifically, the document warned that: 'Temporary dislocation of international financial markets would ensue, if the Saudi Arabian Government ever chose to use its accumulated wealth as a political weapon... Before using its petromoney to secure political goals, Saudi officials would also evaluate the possibility of retaliation and the effectiveness of using money as a weapon. The Saudis would face the possibility that... *the US government would freeze Saudi asset holdings in the United States...*' And the document continued: 'Information on the size and distribution of private Saudi foreign investment is scarce. Investment by private Saudi individuals and corporations may be more destabilising than official Saudi investment, because private individual investors may be more willing to undertake risky or speculative investments than the government'.

Saudi Arabia's withdrawal of dollar liquidity from the US financial system in 1978 was undertaken against the background of a static oil price, heavy Saudi spending commitments and the absence of an opportunity for the cartel to escalate the price further by more than a token margin. At the same time, the dollar was weak again because it was no longer receiving adequate support from the 'transactions' factor. Seen in this light, the Carter package of November 1978 represented a stop-gap measure, involving an enhanced swap arrangement with major central banks to bolster the dollar until such time as the foreign exchange markets could give it a renewed lease of life consequent upon a further quantum leap of the oil price.

Since monopolies are corrupt, it is hardly to be wondered at that the disposition of OPEC countries' wealth is no open book. People who corner commodities and manipulate prices abhor free markets, with the associated freedom of price-setting and the free interchange of relevant information on which that depends. Rather, they thrive on unannounced bilateral arrangements which flourish by satisfying the mutual interests of the participants - but always, of course, at the expense of others.

What is so obnoxious is the spectacle of supposedly democratic governments conniving at, and promoting, cosy bilateral arrangements which exploit a monopoly-distorted price structure. Since the US Treasury has a long record of gradually usurping prerogatives from a sometimes unsuspecting Congress, it has not been surprising to find that the Treasury's international financial policy, like its exploitation of the permissive Federal Financing Bank and government-guaranteed debt arrangements, has developed its own momentum, based on the systematic exploitation of the dollar's proliferation through its link with the cartel's oil.

* * *

THE UNITED STATES-SAUDI ARABIA JOINT COMMISSION

One instrument developed by the US Treasury to exploit these opportunities is the United States-Saudi Arabia Joint Commission on Economic Cooperation, formally established on 8 June 1974 by virtue of a brief joint statement issued without Congressional involvement by the Secretary of State of the day, Dr Henry Kissinger, and the Crown Prince and Deputy Prime Minister of Saudi Arabia, Prince Fahd. In addition to emphasising the mutual desire of the United States and Saudi Arabia to promote 'programs of cooperation between the two countries in the fields of industrialization, trade, manpower, training, agriculture, science and technology', the joint communiqué also contained a single sentence, curiously isolated from the rest of the statement, to the effect that 'the Treasury Department and the Saudi Ministry of Finance will consider general types of cooperation in the area of finance'.

The statutory basis for the Treasury's participation, through this Joint Commission, in Saudi Arabian economic and financial affairs, is to be found first, in legislation dating from 1959, which authorises the President of the United States to intervene, without specific Congressional permission, in the Middle East to promote the prosperity and wellbeing of countries in the region, resorting if necessary to military force in pursuit of such objectives. The legislation enhances the position of the Treasury by clearly authorising it to provide financial and economic assistance.

More importantly, Section 607 of the Foreign Assistance Act (22 USC 2357) states that 'whenever the President determines it to be consistent with and in furtherance of the purpose of Part 1 and within the limitations of this Act, any agency of the United States Government is authorized to furnish services and commodities on an advance-of-funds or reimbursement basis to friendly countries...'. It appears that this required 'determination' was delegated to the Agency for International Development (AID). On 6 June 1975, AID made a determination under Section 607 to permit the Treasury Department to execute its responsibilities in connection with the Joint Commission. The Treasury was authorised to use other official agencies on Commission business.

The Case Act (1USC 112d) requires the Secretary of State to transmit to Congress all international agreements, other than treaties, to which the United States is a party, within 60 days of their entry into force. Project agreements currently being managed through the Joint Commission have indeed been submitted to the Senate Foreign Relations and House International Relations Committees from time to time, in accordance with this legislation. However such reporting merely amounts to the minimal action involved in keeping Congress informed of the bare outlines of the Commission's activities, in conformity with legislated requirements.

In Washington, the Joint Commission's work is handled by the Office of Saudi Arabian Affairs at the Treasury, headed by Mrs Bonnie Pounds; and in Riyadh, it is administered by the Office of the US Representative to the Joint Commission. Technical assistance provided and coordinated by these offices is carried out on a reimbursable basis in accordance with a Technical Cooperation Agreement signed on 13 February 1975 between the US and Saudi Arabian Governments. Under this agreement, the Saudi Arabian Government established a trust fund held by the Treasury against which drawings are made to defray these offices' expenses. The account (Symbol 20X6423) had received total deposits worth $260,213,533.34 by 31 December 1978. With interest and profit earned on securities of $12,716,061.41 and disbursements to date of $175,619,258.83, the account held assets of $97,560,335.92.

At first, the operations of the Joint Commission were financed from the Exchange Stabilization Fund, created in 1934 by the Gold Reserve Act, which placed the Fund under the complete discretionary authority of the Secretary of the Treasury. The General Accounting Office is required, under this Act, as amended on 30 December 1970 (31 USC 822a(b)) to audit only the Fund's administrative expenses, which amounted to a mere $14.4 million in 1975. But in August 1977, the GAO reached agreement with the Treasury whereby the Comptroller-General's Office can obtain access to non-sensitive information concerning operations of the Fund in connection with international monetary and trade policies.

The autonomous Fund, which had assets valued at $4 billion and gross income of $129 million during the year to June 1975[27], is the beneficiary of Special Drawing Rights (SDRs) created by the International Monetary Fund in favour of the United States. When the US first opened its SDR account in 1970, the Exchange Stabilization Fund was designated as the recipient of all SDRs allocated to the United States. The Fund can obtain foreign currencies for the SDRs it possesses, and can exchange US dollars for the SDRs of other countries. Because the Exchange Stabilization Fund's finances are almost completely secret - with even the GAO granted only limited access to them - all official transactions involving SDRs and US dollars are completely confidential. It has been shown that Congressional contributions to the International Monetary Fund are highly 'leveraged' investments, due to a 'hidden' mechanism whereby the Exchange Stabilization Fund operates as a 'revolving fund'. This convenient arrangement is derived from the seemingly straightforward appropriation of funds to the IMF[28].

Bearing in mind that the Exchange Stabilization Fund thus has access to an abundant and self-perpetuating source of revolving finance (its resources, following the creation by the IMF of new allocations of SDRs, are now considerably greater than they were back in 1975), does not depend on Congressional appropriations and is operated in secret at the Treasury Secretary's sole discretion, it is interesting that the General Accounting Office reported[29] in 1977 that Treasury staff paid for out of Exchange Stabilization Fund resources were supporting the Treasury Secretary in a number of projects, including *'development of policy and technical assistance for United States-Saudi Arabian relations'*.

When Congress found out that the Treasury was paying the salaries of the Joint Commission's staff out of such non-appropriated funds - the implication being that the Treasury had not seen fit to request such finance, because it did not want Congress to know in any detail what the Joint Commission was doing - Congress passed Public Law 95-612 on 8 November 1978 (92 STAT 3091), 'prohibiting the Treasury from paying salaries and other administrative expenses associated with its international affairs function with Exchange Stabilization Fund moneys; in the future, such expenses will be paid from appropriations'[30].

The use of joint economic commissions to further US foreign policy objectives is nothing new. Such commissions were established with Egypt, Jordan and certain other countries, as well as Saudi Arabia, as a deliberate instrument of foreign policy to accelerate and enhance the appeasement process following the 1973 oil embargo[31]. But the United States-Saudi Arabia Joint Commission for Economic Cooperation has been more extensively developed by Washington than any of the lesser joint commissions that preceded its establishment - so much so that it has evolved from its original remit as 'an instrument for discussing foreign policy and promoting trade' into:

- An instrument for the active transfer of technology from the United States to Saudi Arabia.
- A means of moulding the developing Saudi Arabian economy in such a way that it complements, supplements and supports the US economy through its function as a captive market for US exports (an objective which the Saudis have sought to frustrate by diversifying their purchases to other countries).
- A mechanism for ensuring, through Commission-generated feasibility studies, that tender documents are geared to US specifications - so that it is only natural that US suppliers should benefit from subsequent contracts.
- An instrument for the active pursuit of the United States' unique bilateral financial, economic and commercial policies towards Saudi Arabia, at the expense of foreign competitors.
- A means of introducing US contractors to the Saudi Arabian market.

Additionally, the Joint Commission performs the important function of training the future generation of technocrats and bureaucrats. Many of these people will in due course be occupying useful positions from the point of view of the United States. To take just one small example, under an agreement signed on 22 June 1978, the United States is training Saudi customs officers. Some 66 officers have attended or are attending specialised short-term sessions at Memphis State University.

At the end of September 1978, the total stated value of project agreements in progress under the auspices of the Commission was said to be a mere $776 million. On 24 March 1980, total expenditure to date had reportedly reached only $365 million, with only 2 out of 19 projects having been completed. In April 1981, the Commission reported that it had 20 projects in hand, of which 17 had project teams resident in the country. Two projects in the electrical field had been completed. A year earlier, just under 180 experts and staff were said to be based in Riyadh, with a small staff being maintained at the Treasury Department's Office of Saudi Arabian Affairs in Washington.

The skimpy data released, from time to time, from Mrs Pounds' office provide a somewhat misleading impression of what the Commission is doing. Specifically, the expenditure figures which have been published take no account of costs arising, for example, after the initial feasibility studies have been completed. Thus, while the Vocational Training (VOTRAKON) project, which includes a training centre for the construction industry, is expected to cost $250 million (according to a 1978 projection), this calculation did not include the actual cost of construction. The AGWAT (Agriculture and Water Program), POWERGRID (Electrical Services), SANCST (Support for Saudi Arabian National Center for Science and Technology), FININFO (Financial Information Services), AUDIT (auditing assistance), CUSTOMAT (Customs Administration and Training), and DEVEX (Executive Management and Development) projects are all of indefinite duration. Indeed officials themselves disagree about the huge proportions of the sums involved. For example, the Office of Saudi Arabian Affairs' figure concerning the projected value of potential contracts to be awarded under the POWERGRID scheme differs widely from the value of $70 billion mentioned by Mr Bergsten in a speech delivered on 18 March 1980[32]. According to Mrs Pounds' office, the overall contract value was estimated in 1978 at $24 million over a ten-year period. Yet the cost of implementing electrification throughout Saudi Arabia is projected at about $27 billion by the year 2,000. The gravy train is so incredibly large that figures have become meaningless: officials from the same Department were able to quote values 18 months ago which were as much as $43 billion apart.

One of the many issues raised by these activities is the question of whether the Joint Commission is also engaged in funnelling petroliquidity into the pockets of favoured contractors in which Saudi interests have acquired substantial equity holdings, or which they control completely[33]. A case in point, given here as an example, is that of CRS Design Associates of Houston, Texas. This firm is involved in the following projects sponsored by the Joint Commission:

- Financial Information Services (FININFO), being developed under a long-term agreement signed on 3 May 1977 by the Treasury and the Saudi Arabian Ministry of Finance for the establishment of a Financial Information Center in Riyadh (total estimated cost: $22 million). A contract for project management services was awarded by the Treasury to CRS Design Associates under this project, in early 1978[34].
- In the Vocational Training and Construction (VOTRAKON) project, based on an agreement promoted by the Treasury between the US Department of Labor and the Saudi Ministry of Labor and Social Affairs, CRS Design Associates is identified as 'Construction Management (Engineering Services) Contractor[35].
- For the National Center for Financial and Economic Information (NCFEI),

CRS Design Associates is providing construction management services[36].

These facts might not be at all interesting if it were not for the reality that Saudi Arabian interests control, or have a large financial investment in, CRS Design Associates[37,38]. Treasury officials are particularly anxious to stress that all contracts arranged through the good offices of the Commission are put out to tender, with the usual three alternative quotations being required.

While the Joint Commission proceeded with the practical business of pursuing its task as 'an important mechanism for (i) fostering closer political ties between the two countries through economic cooperation, (ii) *assisting Saudi industrialization and development while recycling petrodollars and* (iii) facilitating the flow to Saudi Arabia of American goods, services and technology'[39], the Treasury deployed its talents for creative financial innovation to maximise the objective of fostering Saudi-American financial cooperation, as laid down in the communiqué of 8 June 1974 establishing the Commission. On 7 August that year, the Assistant Secretary of State for Near Eastern and South Asian Affairs summarised this appeasement task as follows[40]:

'*In helping the Saudis to find a way to invest their large and growing financial revenues*, we will give them added incentive to continue to produce oil in the quantities needed to meet world demands at stable, and hopefully lower, price levels'. Things didn't quite work out that way; but the sentiment became fashionable.

For example, the draft of the Trilateral Commission's Energy Task Force, discussed in Washington on 11-13 June 1978, noted (on page 117 of the draft), that 'it is essential... that trilateral governments explore carefully *the kinds of inducements and assurances that would help convince the Saudi leadership to avoid sharp changes in production that would have serious economic consequences, and to make the investments necessary to expand production capacity*. The US has traditionally had a *'special relationship'* with Saudi Arabia that appears to have been responsible, at least in part, for the Saudis' moderate stance on price increases. This relationship is based on the US military and security commitment to the Saudis and it is unlikely that any other trilateral country would be an acceptable alternative'. A note appended to this passage commented additionally that *'this special relationship is not defined in any public document, although it is expressed in part in the 1974* *agreement between the two countries to create bilateral military and economic commissions...*'.

* * *

THE 'ADD-ON' SYSTEM AND THE ISSUE OF CONFIDENTIALITY

Before examining the scope of the parallel involvement of the US military-industrial complex with Saudi Arabia, and some of its associated financial implications, reference should be made to certain initiatives taken by the Treasury to attract Saudi petrodollars into US Government and quasi-official enterprises. In July 1979, Mr Robert Bennett, Executive Vice-President and Chief Financial Officer of the Federal National Mortgage Association (FNMA), told this Subcommittee that *'with the encouragement of the Treasury Department and the Federal Reserve'*, FNMA had, along with other corporations, sought foreign investment for its debt securities... Fannie Mae has allotted to the Federal Reserve Bank of New York $1.546 billion for customers' account. We understand that some of these requests for allotment were made by the Fed on behalf of the Saudi Arabian Monetary Agency (SAMA)... We do know that in 1974, $600 million of our debentures were allotted to the Fed specifically for SAMA'. Frequent meetings were held between Mr Bennett and his colleagues, and senior financial officials from Kuwait, Saudi Arabia and Venezuela[41], as part of the Association's debt-sales programme. The short-term notes and debentures used by the FNMA to finance its mortgage purchases were marketed through a 117-member selling group, consisting of top quality names - including that of Donaldson, Lufkin and Jenrette, one of the institutions in which Saudi Arabian interests invested heavily in the course of 1978[42].

Even more important, however, was the secret agreement reached between the United States and Saudi Arabia pursuant to the joint financial cooperation agreement of 8 June 1974. This was outlined in a memorandum from Mr Jack F Bennett to the Secretary of State of the day, Dr Henry Kissinger, in February 1975. Under this arrangement[43], the Federal Reserve Bank of New York offered Saudi Arabia (and, later, when they came to hear of it, other Arab official financial institutions, as well) additional amounts of issues of Treasury securities. A report published by the General Accounting Office on 11 June 1979 confirmed that 'in 1974, *the add-on system was originally offered as part of a bilateral financial package to Saudi Arabia. Treasury officials explained that it was created to attract and manage petrodollars.* In 1975, it was offered to other OPEC countries and then extended to all official foreign financial institutions'.

The 'add-on' system enables foreign central banks or monetary authorities to purchase US Treasury securities non-competitively - that is, directly from the Department of the Treasury, but without entering the regular auctions at which the Treasury offers bills, notes and bonds. 'Add-ons' are additional securities in excess of the total announced for any particular issue. The Treasury claims that no country is permitted to purchase more than 20% of the publicised amount of a single offering, including both 'add-ons' and regular bids; while the total which may be purchased at any given offering has apparently, in the past, been limited to $300 million. It is evident that this mechanism enables the Treasury to borrow more than is announced, thereby adding to the 'hidden' proportion of its ballooning debt burden. At the same time, the General Accounting Office has noted that 'add-ons would appear to insulate the direct sale of US securities at auction from some foreign demand. From this insulation, it is possible to infer lower prices and higher interest rates than would otherwise occur'. This is consistent with my own initial belief that the special financial arrangements involved an element of preferential treatment for Saudi Arabia.

The mechanism had earlier been explained in Congressional testimony by Mr Eugene Sherman, a former Vice-President of Merrill, Lynch Government Securities Inc, New York[44]. According to Mr Sherman, 'the Treasury will announce a new note or bond offering... the Treasury then adds on to the amount sold some number, some amount of securities which foreign central banks have requested... *The US Treasury is selling substantial amounts of securities to foreign central banks in excess of those sold in the public market, and is thereby reducing the amount of money the Treasury has to raise on the domestic market'*. This explanation, of course, was incomplete - in that Mr Sherman did not add that the Treasury thereby incurred more debt than was publicly announced - contributing further momentum to the familiar spectacle of the Treasury routinely requesting Congress to agree to a substantial escalation of the statutory debt ceiling, usually after commitments have been made and overspending has taken place. Further confirmation of the existence of these special arrangements was provided by Mr William Simon, in an important interview he gave on 2 March 1979[45].

A central feature of the special financial concordat originally reached with Saudi Arabia in 1974-75, and doubtless elaborated since, is an understanding 'by the United States authorities to respect the confidentiality of Saudi Arabian 'official' arrangements in the US system[46]. The final sentence of Mr Jack F Bennett's February 1975 memorandum to Dr Kissinger states that *'the sine-qua-non for the Saudis in this arrangement is confidentiality and we have assured them that we will do everything in our power to comply with their desires'.* This undertaking culminated in the Treasury's success in prevailing upon Congress to approve the International Investment Survey Act of October 1976, which forbids the disclosure of information about foreign investments contrary to the investors' expressed wishes[47].

As Mr Lisle Widman, formerly Deputy Assistant Treasury Secretary for International Monetary Affairs, explained in a memorandum to Mr Bergsten[48], 'we (the Treasury) can release data by individual country where the data aggregate the holdings of many individuals and firms and thus do not reveal the holdings of a single customer - whether a private firm or the government. This is not the case for some of the Middle East oil-producing nations such as Saudi Arabia. Thus we have to group several countries in order to respect the confidentiality of government holdings'. And in response to a question put to him by this Subcommittee[49], Mr Bergsten observed: '...it is not possible to draw a meaningful line in the abstract to distinguish between 'private' and 'government' investments' - a hint that the dividing line between funds belonging to certain Arab governments and their ruling élites was virtually non-existent, due to the fact that the governments concerned, and these wealthy individual investors, were identical.

In deference to this request for confidentiality, the Treasury has sometimes overstepped the bounds of propriety. This committee has heard how the Federal National Mortgage Association actually established a Netherlands Antilles corporation, with the full approval of the Treasury, for the express purpose of marketing its quasi-official securities abroad - thereby enabling foreign investors in the agency's securities to escape the payment of US or foreign tax on earned interest. A similar proposal was apparently considered by the Federal Home Loan Bank Board, but rejected[50]. In sanctioning the FNMA's Netherlands Antilles subsidiary, which remains in existence, the Treasury unwittingly revealed that it has one set of rules for US taxpayers, who face severe penalties for seeking to avoid their tax liabilities, and another for specially-favoured OPEC holders of surplus petrodollars.

* * *

HAVE US FINANCIAL POLICYMAKERS BEEN DAZZLED BY OPEC'S WEALTH?

We are now on extremely sensitive ground. The corrupting influence of the great wealth being accumulated as a result of an official policy of appeasing the oil cartel has not only spawned secret and bilateral arrangements which

Congress, if advised of them at all, has only been told about retrospectively; but the Treasury is beginning to break its own harsh rules in order to bestow favours on its super-rich clients. The US Treasury is not, it must be said, the only Western Finance Department that stands ready to indulge in such disgraceful discretionary behaviour - although the UK Treasury has so far been less blatant[51].

On the personal level, there are suspicions that officials could benefit - and indeed, that some have benefited - from favours extended to OPEC countries while in office:

'Wealth - especially great wealth - has a dazzling quality; *and this gives rise to the possibility that US policy towards OPEC and current oil price levels may well have been formulated by men who were dazzled by the prospect of acquiring a share in such wealth'*. As Mr Jack A Blum, whose insight this was, told another Congressional Subcommittee in September 1978[52]:

'Many, if not most, of the senior US officials who dealt with these issues are now representing the newly wealthy Middle East countries in one way or another. The list of such operatives includes a clutch of former Ambassadors to the region, two former Central Intelligence Agency chiefs, a former Secretary of State, a former Vice-President, a former Chairman of the Senate Foreign Relations Committee, a former Secretary of the Treasury, a former Under-Secretary of the Treasury, and a large number of former Congressional and Administration officials'. To this list, can be added the names of at least two former US Ambassadors to Saudi Arabia.

'Although, for the most part', Mr Blum continued, 'the men involved are of the highest integrity' - a collective compliment which, of course, should be read upside down - 'the lure of wealth on this scale can bend the judgement of the best of men; *and as long as the door is open and the possibility of getting rich later exists, it will be a devoted man indeed who will suggest shooting the golden goose while he is on the job for the US Government'*. Mr Blum therefore recommended that 'hard and uncompromising rules should be drawn with respect to the extent to which people who make oil pricing policy can subsequently go to work for the principal beneficiaries of high oil prices. If such rules were applied, perhaps the dazzling glamour of fabulous wealth would be dimmed - and other policy options might then be considered'.

It was, as Mr Blum also observed - in what, I think must generally be accepted, was a remarkably perceptive statement - 'a matter of common observation that over a period of time, cartel members are unwilling to make the sacrifices necessary to keep the cartel functioning. Policing a cartel requires hard work, because 'cheaters' abound. Disputes emerge over who must accept production cuts in order to stabilise prices, over the rate at which production facilities can be expanded, over access to preferred customers and stable supply relationships, or distribution of benefits. In normal commercial situations, purchasers of the cartel product constantly test and probe the willingness of the cartel and its members to make the necessary sacrifices by offering them chances to cheat the other members. Eventually, one cartel member gives in to his customer's blandishments, and breaks ranks. That usually means the end of the cartel'.

'In this case, however, *it has been the policy of the United States Government to assist the OPEC governments, and the American international oil companies, in preventing any serious challenge to OPEC petroleum pricing arrangements.* Furthermore, the US Government has encouraged and justified the development of exceedingly highly-priced incremental supplies on the basis of the legitimacy of the cartel price'.

The Energy Department's oil price projection to 1989, shown in Table 2, confirms that this policy remains unchanged.

If the behaviour of US policymakers and the formulation of the Treasury's international financial policy has been influenced by such considerations, there is ample anecdotal evidence of the prevalence of outright corruption in newly-enriched oil-producing countries. For example, the system of 'commissions' paid by foreign corporations to Saudi Arabian middlemen (many from the Royal Family), whose 'good offices' are usually a prerequisite for obtaining contracts, has reportedly reached unprecedented levels of abuse.

Moreover this highly pernicious system of intermediaries and commissions, in which leading personalities are so often involved, creates built-in pressures for projects which might be of minimal benefit to the country as a whole, and a preference for high-cost projects which are likely to enhance the size of the intermediaries' commissions. And as has recently been reported in the British press, Mr A Java, the Director-General of Petromin, wrote submissively to Prince Bandar of Saudi Arabia in May 1980, observing that 'we are holding reserved for you 500,000 barrels per day of Arabian light crude for a period of five years under reference M/31265. We will be pleased to meet with the director of the purchasing organisation which you have selected on 12 June 1980 in Jiddah to arrange this contract'. It has been calculated that, in thus commandeering 912 million barrels of oil, equivalent to some 5% of Saudi Arabia's total oil exports, Prince Bandar stands to collect, after payment of commissions to marketing intermediaries, some $4,563 million at current prices[53].

* * *

THE UNDER-REPORTING OF OFFICIAL RESERVES

Against this murky background, it is entirely consistent that strenuous efforts appear to have been made by certain oil-rich countries to under-report their international reserves. Following complaints in *International Currency Review* in early 1977[54], the International Monetary Fund inserted a line entitled 'SAMA investments' under the heading 'international liquidity' in the Saudi Arabia statistical pages published in *International Financial Statistics*. This line was later renamed 'SAMA other assets', but the data ceased to be published in April 1977.

According to the late Director of the IMF's Bureau of Statistics, Mr Earl Hicks[55], 'Saudi Arabia's reserves could not be considered in the same light as other countries' reserves because the Kingdom is not dependent on them in the same way that other countries are... Their reserves don't act as the same trigger to alert the authorities as in other places. They divide their foreign assets into reserves and investments but they're really all reserves'.

The *Financial Times'* special supplement on Saudi Arabia dated 17 April 1978 carried an inspired rebuttal of *International Currency Review's* published allegations that Saudi Arabia's international reserves were understated in the IMF's statistics. The reason the Saudi authorities were upset was said to be a reference to the existence of a secret agreement whereby, inter alia, the Saudi Arabian Monetary Agency was afforded concessionary investment privileges by the US Treasury through its agent, the Federal Reserve Bank of New York. Specifically, the *Financial Times'* report, clearly based on a briefing by SAMA itself, explained that '...in practice, there is no particular mystery about Saudi Arabia's 'missing billions', as one journal specialising in foreign exchange dramatically asserted in a boring and uninformative investigation into the question early last year... There has certainly not been any formal agreement on this question as the *International Currency Review* reported last year... *The Saudi Arabian Government has been badly upset by allegations that SAMA... has been understating the size of its liquid foreign assets and has* *entered into a series of agreements with the United States which effectively remove a large part of its assets from its own control...'*

'In practice, SAMA's definitions of which assets are or are not liquid are rather different from the definitions normally used in the international banking community. Most important, Treasury bills and other easily discountable securities, which might normally be classed as liquid assets, are regarded by SAMA as investments, because the Monetary Agency holds such enormous quantities that it would be unable to discount them on a significant scale without seriously disturbing the market... For practical purposes... the assets put under the 'reserves' heading by the IMF are predominantly Certificates of Deposit and bank deposits placed exclusively with banks on the approved list...'

But that explanation did not commend itself to the Deutsche Bundesbank, which commented opaquely in its *1978 Annual Report* that 'about $7 billion was removed from the IMF reserve statistics on Saudi Arabia in 1978 on the ground that the sum served as cover for banknotes in circulation'[56]. This reference echoed earlier published complaints[57] about an official explanation given by the Saudi Arabian Monetary Agency for the depletion of its reserves by about $7.69 billion in April 1978. Moreover, in private at least, IMF officials are known to take a highly sceptical view of SAMA's explanation for the disappearance of these funds - arguing that purporting to use them to cover the note issue is historically unprecedented and, by implication, irregular. In any case, details of 'SAMA other assets' have not been reported by the International Monetary Fund since April 1977, and the line will soon, presumably, be eliminated altogether.

The question of the extent to which the international reserves of certain oil-producing states have been understated in order to disguise their magnitude, for public consumption purposes, remains a controversial issue. The evidence suggests that the US Treasury applauds measures taken by the countries concerned to play down the size of their reserves. Thus a Treasury memorandum, entitled 'Hidden Saudi international reserves', prepared for the guidance of officials in 1977, resorted to the familiar Treasury technique of giving a transparently plausible reason for dismissing the allegation as being without foundation[58]:

'ISSUE: The level of Saudi international reserves reported in *International Financial Statistics* by the IMF is substantially below estimates of total Saudi foreign assets. What is the reason for the sizeable discrepancy between estimated Saudi foreign assets and published figures on their reserves? Why does the IMF tolerate the under-reporting? Why are the Saudis trying to hide the extent of their foreign assets?

ANSWER: Comparison of estimates of cumulative current account estimates for the Saudi Arabian economy with their international reserves is to mix apples and oranges. The concept of international reserves is significantly different from the concept of current account balances.

International reserves are, conceptually, the level of certain types of resources maintained by national authorities as a reserve fund for external payments contingencies. The level of a country's international reserves need not reflect total foreign assets of a government or the net international investment position of a country.... We have no reason to believe the Saudis (or any other country) are under-reporting reserves to the IMF'.

Of course no-one was confusing current account accruals with reserves; that is a red herring; and its purpose was to disguise the fact that arbitrary definitional changes had been implemented by the Saudi Arabian Monetary Agency in respect of its foreign exchange holdings in 1974 and April 1978. These had the effect of cumulatively reducing Saudi reserves by about $40.15 billion up to the end of 1979.

In an attempt to scale down its reported international reserves, the definition of 'foreign exchange' used by the Saudi Arabian Monetary Agency in its routine reports to the International Monetary Fund were narrowed in 1974 and again in April 1978, when the mentioned $7.69 billion was suddenly removed from the total, as already explained. As a consequence, discrete drops in reported reserves appeared in the country's foreign exchange reserves totals for 1974 and 1978, as published by the Fund. Additionally, the published foreign exchange component of Saudi Arabia's international reserves has become progressively more understated over time, because the Saudis have continued to accumulate funds in categories which would previously have been described as foreign exchange, but are not described as such any longer[59].

The August 1981 issue of *International Financial Statistics* shows that the[60] Saudi Arabian Monetary Agency held published foreign assets of $80.4 billion in October 1980 (the latest date for which a figure was available), of which under-reported foreign exchange reserves amounted to $21.9 billion. Addition of the gold component and the 'missing' $40.2 billion, reveals foreign reserves, excluding Special Drawing Rights and Saudi Arabia's Reserve Position in the IMF, of $98.8 billion at that date.

Nor is Saudi Arabia's practice of under-reporting its reserves unique. A glance at *International Financial Statistics* will reveal that credence cannot be placed in the international reserves figures published for Kuwait, the United Arab Emirates or Qatar - in Kuwait's case, partly because reserves are held by various official institutions, including the Kuwait Fund and the Kuwait Investment Office in London; and in the case of the United Arab Emirates, because Sheikh Zayed of Abu Dhabi refuses to aggregate his substantial accruals at the United Arab Emirates Central Bank. The reputation of that institution, previously known as the UAE Currency Board, has never really recovered from rumoured scandals surrounding the irregular disbursement of its funds during the tenure as Managing Director of a former Bank of England employee and IMF appointee, Mr Ronald Scott. As for the reserve figures published by Qatar, which earned $19,839 billion in 1974-80 from exported oil, the total reported value of that country's international reserves minus gold stood at only $343.4 million at the end of last year - hardly a figure likely to inspire confidence!

This is all highly disturbing to objective observers - not least the Bundesbank, which has made it clear that it will not let the matter rest. In its *1980 Annual Report*[61], the West German central bank notes that 'the reserve statistics of the IMF do not cover liquid investments by quasi-official institutions or other funds with the character of reserves, which have increased considerably in recent years. This has become known on the basis of partial data, in particular information on the investment policy of the OPEC countries. *The figures published by the IMF therefore give an incomplete picture of the development of international liquidity.* <u>This could lead to an underestimation of the expansion of liquidity caused by the way in which high current account balances are financed</u>, and to the neglect of the problems this raises. It therefore appears urgent to search for ways and means of adjusting international reserve statistics to the actual situation, so as to enable the development of international liquidity to be assessed accurately in future, as well'. Note that the words underlined in this passage confirm that the Bundesbank's interpretation of how petromoney is created to finance cartelised oil prices is exactly consonant with the explanation given at the beginning of this survey.

* * *

OTHER WORRYING MACRO-DISCREPANCIES

While the Bundesbank has given its blessing to this worrying explanation for the evident under-reporting of international reserves - despite contrary explanations, inter alia, from the Saudi Arabian Monetary Agency, explanations for various other significant macro-discrepancies which have ballooned with the oil monopoly-induced expansion of international liquidity are not so readily available. The International Monetary Fund cites a substantial accumulated negative residual asymmetry of $112 billion on the global current account in 1977-81 inclusive (see Table 7), for which it offers no explanation[62]. In a report published in 1979, the General Accounting Office identified a positive accumulated unexplained residual in global current account balances, including official transfers, of $47 billion (Table 8). The global trade balance of IMF member countries showed an accumulated 'loss' of $390.2 billion in 1950-80 inclusive (see Table 9). And the difference between the foreign

Category	1977	1978	1979	1980	1981
Industrialised countries	- 6	30	- 11	- 44	- 29
Developing countries:					
Oil exporting countries	31	3	68	112	96
Non-oil developing countries	- 29	- 38	- 58	- 82	- 97
Fund members and others[1]	- 3	- 4	- 1	- 14	- 30
Other countries	- 7	- 4	- 1	- 1	- 3
Union of Soviet Socialist Republics and Eastern Europe	- 8	- 5	- 3	- 4	- 6
Total	- 10	- 8	- 2	- 15	- 33
Less timing asymmetry on trade	8	10	19	10	3
Residual asymmetry[2]	- 18	- 18	- 21	- 25	- 30

Table 7: World payments on current account, 1977-80 (goods, services and private transfers), in billions of US dollars. Notes: [1]Includes Switzerland and certain essentially autonomous dependent territories (notably, for example, Hong Kong); [2]Reflects statistical errors and asymmetries.

Source: International Monetary Fund.

	1974	1975	1976	1977	1978
OPEC	+69.5	+34	+36	+33.0	+ 7.5
OECD	-27.5	0	-19	-27.0	+ 1.0
United States	(+ 2.0)	(+18)	(+ 4)	(-15.0)	(-16.5)
Others	(-29.5)	(-18)	(-23)	(-11.5)	(+17.5)
Non-oil LDCs	-24.0	-28	-19	-14.0	-18.0
Others	- 9.5	-18	-11	- 9.0	- 9.0
Unexplained residual	- 8.5	+ 8	+14	+17.0	+16.5

Table 8: The unexplained residual in global payments patterns, in billions of US dollars (= current account balances, including official transfers).

Source: General Accounting Office.

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Year	Exports	Imports	Balance
1950	57.2	59.6	- 2.4
1951	77.5	82.3	- 4.8
1952	74.5	81.4	- 6.9
1953	75.5	77.4	- 1.9
1954	77.8	80.4	- 2.6
1955	84.8	90.3	- 5.5
1956	94.5	99.4	- 4.9
1957	101.6	109.1	- 7.5
1958	96.5	101.8	- 5.3
1959	102.4	108.1	- 5.7
1960	114.5	121.1	- 6.6
1961	119.7	126.8	- 7.1
1962	125.1	133.9	- 8.8
1963	137.3	145.8	- 8.5
1964	153.9	162.1	- 8.2
1965	167.0	176.1	- 9.1
1966	183.5	193.7	- 10.2
1967	192.6	203.3	- 10.7
1968	214.9	226.1	- 11.2
1969	246.3	257.7	- 11.4
1970	283.4	296.6	- 13.2
1971	317.4	331.6	- 14.2
1972	376.9	389.2	- 12.3
1973	524.4	536.4	- 12.0
1974	774.1	785.3	- 11.2
1975	796.8	814.1	- 17.3
1976	907.5	922.7	- 15.2
1977	1,030.6	1,060.2	- 29.6
1978	1,193.4	1,229.4	- 36.0
1979	1,510.9	1,551.1	- 40.2
1980	1,846.0	1,895.7	- 49.7
Total:	12,058.7	12,448.7	-390.2

Table 9: The global trade balance (of IMF member countries), 1950-80. This table shows that the world incurred a trade deficit with itself of $390.2 billion during the period (data in billions of US dollars.

Sources: International Monetary Fund; London Currency Report.

assets and liabilities of deposit banks in IMF member countries amounted to $69.1 billion at the end of fiscal 1981 (see Table 10), compared with $31.2 billion in 1973.

Many attempts have been made to explain these various discrepancies, but there have been no definitive answers. This reflects the fact that, when dealing with aggregates compiled from national statistics, the scope for error is both large and unknown. Thus, for example, some countries may use reporting procedures which exaggerate their exports. Imports may be lower because of pilferage and losses en route. Inadequacies of reporting procedures may be exacerbated by leads and lags. 'Commissions' paid to

Year	Foreign assets	Foreign liabilities	Difference
1973	355.2	386.4	-31.2
1974	459.6	503.7	-44.1
1975	555.9	578.5	-22.6
1976	684.4	714.2	-29.8
1977	859.4	884.9	-25.5
1978	1,122.7	1,143.8	-21.1
1979	1,413.0	1,483.0	-70.0
1980	1,711.1	1,777.9	-66.8
Apr 1981	1,747.7	1,816.8	-69.1

Table 10: Foreign assets and liabilities of deposit banks in IMF member countries, in billions of US dollars.

Sources: International Monetary Fund; London Currency Report.

middlemen are 'lost'. Bribery is clearly an extremely important factor, if recent investigations by the General Accounting Office[63] are to be believed. More than 30% of US corporations completing a GAO questionnaire monitoring the impact of the Foreign Corrupt Practises Act of December 1977 responded that the anti-bribery provisions of the legislation were a cause of US companies losing business. Some 60% of the 188 'Fortune 1000' corporations admitted that the Act had influenced changes in their standards of business conduct; while over 50% of aircraft and construction companies admitted that they had lost overseas business. The implication was that, had they been able to continue their practice of using 'off-books slush funds'[64] to ingratiate their organisations with foreign purchasers, their export sales results would have been considerably healthier.

While speculation concerning global macro-discrepancies which have been given here as examples is bound to be frustrated, and may therefore prove largely unenlightening, investigations to establish the causes of the US balance-of-payments discrepancy (see Table 11) could prove more fruitful. Between 1975 and 1980 inclusive, the United States ran a 'positive' balance-of-payments shortfall of nearly $76 billion. Prior to its recent downward revision by the Department of Commerce, this discrepancy was thought to have amounted to almost $86 billion. During the first quarter of 1981, the discrepancy, at a provisional $6.8 billion, was running at an annualised rate of over $27 billion. In the second quarter of 1980, the discrepancy amounted to no less than $18.2 billion[65].

Extraordinary quarterly variations in the size of the discrepancy are commonplace. Thus, although it rose from $11,398 million in 1978 to $21,140

Period	Prior to recent revision[1]	As recently revised[2]
1972	- 1,879	- 1,879
1973	- 2,654	- 2,654
1974	- 1,620	- 1,620
1975	5,763	5,753
1976	10,367	10,367
1977	- 880	- 2,323
1978	11,354	11,398
1979Q1	3,022	3,430
1979Q2	10,375	9,309
1979Q3	- 833	- 455
1979Q4	11,202	8,857
1979:	23,765	21,140
1980Q1	6,981	6,073
1980Q2	20,200	18,151
1980Q3	2,879	2,676
1980Q4	5,544	2,736
1980:	35,605	29,640
1981Q1	-	6,799
1975-80:	85,974	75,975

Table 11: Statistical discrepancy of the US balance-of-payments, in millions of dollars. Notes: [1]Sources: Economic Indicators (Joint Economic Committee of Congress), May 1981 and July 1980; Survey of Current Business, Commerce Department, April 1981; [2]Economic Indicators using Commerce Department data (series revised), June 1981.

million in 1979 and $29,640 million in the following year, the discrepancy of more than $18 billion in April-June 1980 was followed by two quarters in which the shortfalls amounted to about $2.7 billion.

Concerned about this state of affairs, the Office of Federal Policy and Standards at the Department of Commerce has established a special working party - the Inter-Agency Committee on Balance-of-Payments Statistics. Members of this Committee's Work Group - consisting of two officers from the Department of Commerce, one from the Treasury and one from the Federal Reserve Board - have held a series of meetings with banks, corporations and investment brokers, in an attempt to identify financial market developments which might have led to a large increase in unrecorded credits.

The Group's review has highlighted the growing use of international banking facilities by US corporations - not a particularly enlightening discovery. At the same time, it would appear that flows through the commodities markets have ballooned. One major brokerage firm told the Work Group in January that their commodities commissions now equalled their securities commissions, and had quadrupled in the past four years.

The Group considered the possibility that some eurodollar market borrowing undertaken by US firms is being done by the foreign subsidiaries of US non-banking firms - and used to generate financial flows to the parents, which are not being identified as direct investment income. The general view of the Group, however, is that there is little probability that the unreported amounts of such flows can be substantial. There may be a serious problem with the reporting of private placements of debt securities, however; and this possibility is currently the subject of some speculation and concern.

According to an interim report prepared by the Department of Commerce on this work[66], the huge random quarterly variations in the size of the balance-of-payments discrepancy rule out any single cause - although the logic underlying this conclusion is not altogether clear. The working party says that it has sought explanations in factors such as the structure of US interest rates, US government policies or changes in foreign asset-holders' preferences, which might have been expected to have shifted the flow of capital from well-reported channels to others which are less adequately covered by the established Treasury balance-of-payments reporting system. Specifically, it is thought that recent financial market developments may have stimulated a large increase in unrecorded credits. For example, evidence assembled by the Work Group suggests that a significant proportion of the large unrecorded inflows in 1980, particularly the $18 billion recorded during the second quarter, were associated with unrecorded euromarket borrowings.

On this analysis, the Federal Reserve's credit restraint policy will have made it hard for US corporations to obtain funds for domestic use from their usual domestic banking sources. As a consequence, the companies may have turned to other channels - including the eurodollar markets - obtaining the required funds either from foreign banks or from the foreign offices of US banks.

The Work Group reported that a noticeable increase in foreign bank activity had been observed in the US financial markets. Several firms consulted, including some banks, said that the foreign banks had been particularly active in soliciting American business - often offering loans at lower rates of interest than those offered by US banks. The sourcing of such loans is not always apparent to the borrowers.

The institutions advised that various rates are typically quoted. Floating rate pricing formulas are based on the prime rate, the Federal funds rate, on the London Interbank Offered Rate (LIBOR), or on the 'cost of funds'. While the more conservative banks are careful to match pricing and sourcing, so that loans priced at LIBOR, for example, are indeed booked in the euro-markets, the Committee found, in one instance, that loans are also priced at LIBOR, and funded with New York Certificates of Deposit. Bearing in mind the extreme competitive pressures motivating some aggressive foreign banks, these varying loan pricing packages are also, as a consequence, now being offered by the American banks.

One increasingly popular form of loan contract provides the borrower with a financing option, whereby a loan may be priced at some New York-based rate (prime and Federal funds rate being the most common), or at LIBOR - whichever is the lowest rate. The borrower then has the option to switch from the higher rate to the lower rate, during the term of the loan. Most contracts appear to provide for such switching, at a three-month or six-month rollover date. A considerable amount of such switching took place during the second quarter of 1980.

Internal treatment of these different kinds of international borrowings varies sharply between banks, and between borrowing firms. Officials say that one major international borrower made no attempt to ascertain the source of funds borrowed, and so was consequently in no position to report such borrowings as is required on the Treasury International Capital (TIC) Form CQ-1. Officials were left in little doubt that corporate treasuries were preoccupied with other concerns, and that reporting details were generally left to lower-ranking personnel in the corporate controllers' departments.

Since many loans thus booked abroad, either as straight eurodollar market loans or as 'either-or' borrowings, are serviced by the New York banking offices on behalf of their foreign branches, the point that a given loan may in fact be booked in Nassau or London, may totally escape the controller's bookkeeper who services the loan or who fills out the Treasury International Capital reporting form; so that his reporting responsibility may thus be overlooked. One firm visited by the Work Group discovered, on investigation, that they had a number of such borrowings on their books - that is to say, foreign borrowings treated as domestic ones, which were therefore not reported.

But although some of the balance-of-payments discrepancy can doubtless be identified by such enquiries, other possible causes remain to be investigated. These include substantial leading and lagging of trade credits, evident from

Treasury foreign currency data, reporting problems associated with private placements - which, as already noted, may well turn out to be a fruitful area for enquiry; the impact of trading in commodity and financial futures, and the concurrent growth of foreign involvement in such transactions; significant inflows of foreign funds into the real estate market; and the possibility of large inflows into limited partnership interests. The question of whether the reporting system used to compile current account statistics is wholly 'watertight' may also require examination.

* * *

UNDERGROUND NARCOTICS TRADE NOT MENTIONED

Even so, it was somewhat surprising that the Work Group's interim report made no reference to the dimensions of the underground economy - notably, the impact of financial flows associated with the illicit drug trade. According to investigations carried out by the Treasury and the General Accounting Office, the flow-of-funds associated with illegal drug trafficking has reached extraordinary proportions. A GAO report[67] published in October 1979 revealed that payments by abusers and traffickers for heroin, cocaine, marijuana and hashish in the United States were then estimated to be worth between $35 and $51 billion annually. Drug trafficking today appealed to people from all walks of life, including doctors, lawyers, accountants, businessmen and entertainers. The marijuana market alone consumed between 60,000 and 91,000 pounds a day, resulting in expenditure of $13-$21 billion annually.

A substantial proportion of heroin imported into the United States comes from the Middle East - with opium production dwarfing production in Mexico and the so-called Golden Triangle of South-East Asia. Illicitly produced heroin originating from opium grown in Turkey, India, Lebanon and Egypt, together with other narcotics from Afghanistan and Pakistan, enters the US market on an increasing scale (although flows from Afghanistan may have diminished since the Soviet invasion). Since the revolution in Iran, Iranian growers have apparently assumed greater importance than in the past.

Thanks to vigorous (though some complain, insufficiently vigorous) efforts by the Treasury to enforce reporting requirements under the Bank Secrecy Act of 1970 - in particular, investigations sparked by information collected on bank reporting Forms 4789 - some modest progress is being made in reaching an understanding of the dimensions of this industry. For example, in the course of Treasury investigations to establish the sources of $14 billion of surplus currency deposited by Florida banks at the Federal Reserve Bank offices in Miami and Jacksonville during 1978-80 - money which was surplus to the supply of currency released to that area by the Fed - more than 25 banks have been identified as having handled amounts of questionable funds[68]. Officials believe that this investigation is revealing 'only the tip of the iceberg'[69]. By July this year, criminal investigations into the activities of 21 Florida banks had been authorised, with charges including income tax evasion, Bank Secrecy Act violations, and drug-related activities. In the Black Tuna case, prosecuted in 1980 and initiated following examination of Forms 4789, one of the principals was sentenced to 54 years in prison, and was alleged to have handled hundreds of millions of dollars' worth of marijuana.

The Treasury attaches exceptional importance to the Florida investigation, which 'involves billions of dollars and promises to be one of the largest financial investigations ever undertaken'[70]. The Treasury Department has indicated its strong opposition to proposals that the relevant Bank Secrecy Act requirements should be terminated in 1984, on the ground that the main beneficiaries would be drug traffickers 'at a time when the drug problem is assuming monumental proportions in the nation'[71].

From this evidence, it can reasonably be argued that any relaxation of the bank reporting requirements under the 1970 Act would also leave the Treasury without any means of even being able to estimate the size of the drug trafficking industry, which is assumed to account for a significant proportion of the turnover of the black economy in the United States. At the same time, any such relaxation would surely render useless efforts made by officials to determine the factors underlying critical statistical discrepancies - including the balance-of-payments discrepancy.

This is because if large areas of uncertainty remain unclarified, it will never be possible, surely, to bring investigations of other discrepancies to a successful conclusion. The Commerce Department's working group is nowhere near identifying the causes of the balance-of-payments shortfall. But even if it had claimed to have done so, it would have been difficult, in view of what the Treasury says about the financial proportions of the illicit drug trafficking industry, to take any such conclusions seriously. Put another way, these colossal macro-discrepancies are really indivisible. While doubts remain over one group of macro-anomalies, progress made in identifying the sources of others is bound to be slow.

* * *

PETRO-FINANCIAL FLOWS RELATED TO MILITARY ACTIVITIES

One critical area - the geofinancial implications of US military-industrial sales and construction contracts - remains to be considered. This is such a vast subject that no summary can possibly do it justice. For clarity, these remarks are confined to certain reflections on the overal dimensions of US military transactions with some foreign countries, especially Saudi Arabia, and their financial consequences. All kinds of disturbing questions arise when considering these matters - only some of which can be usefully addressed without access to confidential material.

Since 1970, the Department of Defense has operated a system of military trust funds on behalf of client countries. The purpose of these funds is to hold advance payments which are supposed to protect the US Government against loss due to cancellation or other factors. Specifically, the Department has normally required foreign customers to deposit, in advance, amounts sufficient to cover, on a continuing basis, all costs and damages associated with sales agreements - including potential termination costs. Many 'friendly' countries maintain such accounts with the Treasury.

At 1 September 1980, these advance deposits, consolidated in an overall trust fund account maintained by the Treasury, aggregated $8.5 billion. In fiscal 1978 and 1979, between $8 billion and $9 billion was deposited and disbursed from the overall trust fund annually, with the average trust fund balance reported as about $6 billion.

Some $5 billion of the $8.5 billion total as at 1 September 1980 was held in escrow-type accounts at the Treasury; while the remaining $3.5 billion initially deposited in military trust funds had been transferred, at the client countries' specific request, to interest-bearing accounts either with Federal Reserve Banks, or with commercial banks[72].

<u>Table 12</u> summarises the amounts which had been deposited outside the Treasury in interest-bearing accounts at 30 September 1980. A total of 12 countries had taken advantage of a precedent apparently set by Saudi Arabia which had objected to its military deposit funds being sterlised at the Treasury. After the Carter Administration approved Saudi Arabia's request for a proportion of the money to be placed in an interest-bearing deposit account in August 1979, Switzerland, Korea, Taiwan and the United Kingdom were authorised to deposit reserve and excess foreign military sales funds with the Reserve Bank of New

Country	Financial institution	Balance
Belgium	Commercial Bank	$ 36,710,859
Denmark	Commercial Bank	18,678,322
Germany	Treasury	113,490,390
Germany	Treasury	1,911,452
Italy	Treasury	363,895
Korea[1]	Federal Reserve Bank of New York	75,400,000
Netherlands	Commercial Bank	60,000,000
Netherlands	Treasury	68,788,636
Norway	Commercial Bank	55,455,851
Saudi Arabia	Federal Reserve Bank of New York	2,802,035,599
Switzerland	Federal Reserve Bank of New York	141,800,356
Taiwan	Federal Reserve Bank of New York	70,188,946
United Kingdom	Federal Reserve Bank of New York	65,492,834
Venezuela[2]	Commercial Bank	833,533
Venezuela[3]	Commercial Bank	3,906,330
Total:		$3,515,057,003

Table 12: Interest-bearing accounts established for selected countries holding deposit funds from military trust funds, established following the Carter Administration's August 1979 decision to accede to Saudi Arabia's request for such funds to earn interest in their favour. Notes: 1: balance at 9 Sep 1980; 2: balance at 5 Sep 1980; 3: balance at 3 Sep 1980.

Source: General Accounting Office.

York. Other countries were authorised to deposit excess funds in commercial bank accounts.

Table 13 summarises activity in the Iranian military trust fund with the Treasury, over a period of 30 months ending on 30 September 1979. It shows disbursements from the account of about $119 million per month, aggregating $3,564.4 million over the period. Under the deposits column, against entries for September 1979, it will be observed that about $2 million was removed from the fund, on account of 'an erroneous posting of Saudi Arabian deposits to the Iranian trust fund in April 1979'[73].

The table shows a balance of $485 million in Iran's trust fund at 30 September 1979. However activity in this account had, since the Iranian revolution, reflected the consequences of the Islamic Government's unilateral cancellation of existing arms purchase agreements with the United States. At cancellation, Iran's military trust fund balance stood at about $640 billion, and the total value of its undelivered military sales orders with the United States amounted to $12.6 billion.

Iranian items were quickly diverted to other buyers - with over $640 million being credited to the Iranian trust fund between March and the end of September 1979 as items earmarked to Iran were sold to other customers - including the US Navy, which transferred $491 million to the account, for the purchase of Spruance class destroyers which had been ordered for the Shah. The Navy also purchased $36 million worth of other Iranian goods, while the US Air Force transferred $56 million to the account to cover the diversion of

Date	Deposits	Disbursements	Balance
Balance as of 31 Mar 1977:			661,622,161
Apr 1977	63,816,945	198,114,564	527,324,542
May	15,449,968	189,827,809	352,946,701
Jun	384,602,905	215,946,606	521,603,000
Jul	174,246,850	159,912,056	535,937,794
Aug	18,656,312	112,590,916	442,003,190
Sep	478,473,111	250,029,514	670,446,787
Oct	117,031,385	64,571,213	722,906,959
Nov	1,986,432	190,289,959	534,603,432
Dec	260,299,321	128,288,201	666,614,552
Jan 1978	218,914,000	75,004,902	810,523,650
Feb	31,059,300	83,263,134	758,319,816
Mar	350,326,912	363,057,295	745,589,433
Apr	185,777,907	174,096,137	757,271,203
May	6,063,794	106,542,454	656,792,543
Jun	86,305,808	232,270,569	510,827,782
Jul	226,728,617	135,219,160	602,337,239
Aug	30,737,367	165,214,734	467,859,872
Sep	17,020,846	63,138,438	421,742,280
Oct	218,324,625	111,472,627	528,594,278
Nov	175,487,262	102,774,067	601,307,473
Dec	120,031,876	174,394,209	546,945,140
Jan 1979	227,528,582	126,072,736	648,400,986
Feb	128	120,957,669	527,443,445
Mar	146	169,305,191	358,138,400
Apr	8,347,017	21,973,350[1]	344,512,067[1]
May	219,776	61,979,247	282,752,596
Jun	632,051	138,192,537	145,192,110
Jul	2,932	(421,021,289)[2]	566,216,331
Aug	-	47,359,905	518,856,426
Sep	(1,963,814)[3]	31,602,236	485,290,376[4]
Total:	3,416,108,361	3,564,440,146	

Table 13: Schedule of Iranian Military Trust Fund activity for the 30-month period ending 30 September 1979, in dollars. Notes: [1]Refunds from the Air Force and Army of $34 million and $19 million, respectively, were credited against disbursements. Also, the account was credited for $37.6 million for the diversion of the F-16 aircraft to a second buyer; [2]A refund from the Navy of $490.5 million was credited against disbursements for the purchase of the Spruance-class destroyers; [3]Adjustment resulting from erroneous posting of Saudi Arabian deposits to Iranian trust fund for April 1979; [4]Defense officials estimate the trust fund balance will be approximately $80 million at programme completion.

Sources: General Accounting Office; International Currency Review.

Date	Deposits	Disbursements	Balance
Balance as of 30 Sep 1977:			658,174,625
Oct 1977	61,542,983	50,499,745	669,217,863
Nov 1977	461,318,683	160,318,926	970,217,620
Dec 1977	37,680,216	81,882,390	926,015,446
Jan 1978	220,774,810	104,428,736	1,042,361,520
Feb 1978	766,862,836	74,449,980	1,734,774,376
Mar 1978	245,518,535	246,815,200	1,733,477,711
Apr 1978	103,657,355	252,617,118	1,584,517,948
May 1978	426,449,947	(17,230,342)	2,028,198,237
Jun 1978	23,096,936	274,750,849	1,776,544,324
Jul 1978	415,339,216	207,504,834	1,984,378,706
Aug 1978	47,085,175	275,327,446	1,756,136,435
Sep 1978	220,654,713	148,096,560	1,828,694,588
Oct 1978	124,363,674	202,604,839	1,750,453,423
Nov 1978	665,744,214	188,316,356	2,227,881,281
Dec 1978	137,255,824	201,431,773	2,163,705,332
Jan 1979	257,786,650	215,468,439	2,206,023,543
Feb 1979	195,640,392	195,363,370	2,206,300,565
Mar 1979	141,091,111	258,782,523	2,088,609,153
Apr 1979	250,914,810	214,920,380	2,124,603,583
May 1979	(42,662,106)[1]	226,870,506	1,855,070,971
Jun 1979	283,791,167	245,343,948	1,893,518,190
Jul 1979	397,279,140	223,759,582	2,067,037,748
Aug 1979	280,912,634	227,425,131	2,120,525,251
Sep 1979	22,505,980	237,687,703	1,905,343,528
Total:	5,744,604,895	4,497,435,992	

Table 14: Schedule of Saudi Arabian Military Trust Fund activity for the 24-month period ending 30 September 1979, in dollars. Note: [1]Transferred to the Jordan Military Trust Fund account.

Source: General Accounting Office.

F-16 aircraft and the purchase of inventory items. However the Air Force did not reimburse the Iranian trust fund with about $263 million, being the cost of particular requirements negotiated by the Shah's Government, such as an Iran-based navigational computer centre, for which the US Navy obviously had no requirement.

Table 14 summarises activity in the Saudi Arabian military trust fund over a 24-month period ending on 30 September 1979. Deposits in this account averaged $239 million per month, aggregating $5.7 billion over the period; while disbursements, at $4.5 billion, averaged $187 million per month. It should be noted that neither of these accounts actually gives any indication of the true extent to which Saudi petrodollars are being funnelled into the US military-industrial complex - since their purpose, as noted, is to hold sufficient funds to protect the US Government against the financial consequences of cancellations or other unforeseen developments. Even so, the importance of the trust funds is clearly greater than was implied by Sharif Ghalib, Vice-President of Chase Manhattan Bank, New York, in an article published in the April 1980 issue of *Euromoney*, in which he observed that holdings of the Saudi Arabian trust fund account with the US Treasury 'are relatively modest, averaging $75 million during the 44 months ended June 1979, according to the General Accounting Office report to Congress of 11 June 1979'.

The implication here is that the sums held in military trust funds at the Treasury are not significant 'hidden' placements of petroliquidity in the US financial system. But since these accounts are essentially operated as 'revolving funds', and the size of the current military order book managed by the Department of Defense had reached $53 billion at September 1980 (and must be far larger now), Mr Ghalib's interpretation ought to be rejected. Nor is it clear whether the trust fund moneys are recorded in the US balance-of-payments statistics.

A Treasury official has told me privately that the holdings of foreign countries in US military trust fund accounts are not reported in the balance-of-payments. On the other hand, Mr Christopher Bach, at the Department of Commerce, expressed surprise when confronted with this interpretation, and told me that he thought they should be included. Specifically, he advised that the funds transferred from military trust fund accounts into interest-bearing accounts at Federal Reserve Banks or commercial banks since August 1979 are definitely captured in routine official financial reporting data. He said that he would want to investigate the possibility that resources held in certain military trust funds at the Treasury, possibly in that of Saudi Arabia, are not reported - as my Treasury contact has confirmed is the case. Should it transpire that military trust fund accounts are not reported, the conclusion will have to be that here is another source of liquidity over which, like the resources of the Exchange Stabilization Fund, the Congress exercises no control, although the General Accounting Office obviously has access to these accounts.

* * *

SCOPE OF SAUDI-RELATED MILITARY FINANCIAL FLOWS

Between fiscal 1950 and 30 September 1976, US military sales to Saudi Arabia amounted to $12.1 billion, of which $8.2 billion worth of sales were recorded between fiscal years 1972 and 1976. Of the $12.1 billion total, over 60% represented the value of construction projects for which the US Army Corps of Engineers had management responsibility[74]. In fiscal 1977-79, the Saudi

Arabian Government signed sales agreements with the Department of Defense valued at $1.9 billion, $4.1 billion and $6.4 billion respectively; and by 30 September 1979, the Saudi Arabian Government had $22.2 billion of undelivered 'foreign military sales orders'[75]. A General Accounting Office source explains that these agreements, which covered the purchase of weapons systems such as F-5 and 60 F-15 fighter-bomber aircraft, together with TOW, Dragon and Maverick missiles, 'represented the value of signed agreements between the United States and Saudi Arabia and not the value of contracts entered into by the United States with its contractors on behalf of Saudi Arabia'. This cryptic remark indicates that Uncle Sam makes a profit from acting as sales agent in respect of these lucrative contracts. There may well be some 'leakage' of petroliquidity into the system as a result of this.

In addition to having placed $22.2 billion of undelivered military sales orders at 30 September 1979, the Saudi Arabian Government had incurred outstanding construction contracts through the programme administered by the US Army Corps of Engineers, worth about $13.5 billion; while the projected total value of the construction programme, as then formulated, was $21 billion. Sales agreements signed between the Corps of Engineers and the Saudi Arabian Government were valued at $700 million in fiscal 1977, and increased to about $2 billion in fiscal 1978 and 1979. The available documentation is ambiguous as to whether there is any overlapping, but it would appear that the foreign military sales orders, construction programme costs and sales agreements reached separately with the Corps of Engineers represent separate streams of expenditure.

The construction programme involves such activities as the design and construction of naval port facilities, military air bases, infantry and artillery centres, and family housing and medical facilities. At the end of September 1979, the total value of Saudi 'undelivered military sales', construction work in hand and projected, and separate sales agreements with the Corps of Engineers, aggregated $47.9 billion. This total, of course, must by now be wildly out of date - since it refers to a period before the military-industrial complex decided that it would be appropriate to supplement 'continued flights of US Air Force AWACs now operating over Saudi Arabia'[76]. by adding fuel tanks to the F-15s, providing Sidewinder missiles, other support equipment and installations, and by selling AWACs aircraft to the Saudi régime'. No doubt the idea is that these aircraft should continue to be operated by US crews and technicians, for a period of years - and that such equipment will not, in any case, contain the most sophisticated intelligence-gathering installations[77]. If Riyadh is eager to purchase sophisticated equipment which the United States urgently needs to deploy to a sensitive region, what more harmonious community of interests could be imagined than one which satisfies Saudi Arabia's pride by enabling it to own and pay for the equipment with recycled petroliquidity - while the aircraft continue, in practice, to be operated exclusively by trained US personnel?

On 7 April, Mr Mavroules told the House of Representatives that 'since 1976, the United States has sold more military equipment to Saudi Arabia than to any other non-NATO country. The total is more than $22 billion in weapons. In 1980, the purchases of our military equipment and construction amounted to about $5 billion'[78]. Saudi Arabia's military purchases account for a significant proportion of the total value of the United States' overall military sales programme, which consisted at 30 September of '$53 billion in open foreign military sales orders'[79]. Of this total, the 12 countries listed in Table 12 as having interest-bearing accounts to hold some of their trust fund balances accounted for sales orders worth a total of $33 billion. Note the official use of the word 'open' in describing the foreign military sales orders - implying the existence of a separate, unreported, secret military sales order book generating no doubt substantial additional financial flows.

In 1967, the Foreign Military Sales programme (FMS) apparently involved sales worth about $1 billion[80]. In fiscal 1975, the value of orders in hand rose to $10 billion; and in fiscal 1977, they aggregated $11.2 billion. In the 1980 financial year, over $15 billion of total 'open' foreign military sales billings were reported.

It transpires that Saudi Arabia's financial arrangements with the Department of Defense and the Treasury in respect of its military transactions differ from those of other countries[81]. Traditionally, Saudi Arabia has financed a proportion of its long-established letter-of-credit arrangements with Chase Manhattan Bank. The letter-of-credit arrangements do not directly affect the Saudi Arabian balance in the military trust fund. Under these arrangements, Saudi Arabia deposits funds needed to finance operations of the Corps of Engineers with Chase Manhattan Bank, and the Corps draws on the letters-of-credit as costs are incurred, reporting this to the Defense Security Assistance Agency in Denver. At 30 September 1979, the letter-of-credit to cover the Engineering Assistance agreement programme was valued at more than $3.4 billion, and the Corps had drawn down more than $2.7 billion. Other letters-of-credit valued at about $737 million were available to finance the Saudi Arabian naval expansion programme and construction management activity, all handled through the US Army Corps of Engineers.

In addition, as already explained, Saudi Arabia holds further funds on deposit both at its military trust fund, and in an interest-bearing account at the Federal Reserve Bank of New York (see Table 12 which shows that, at 30 September 1980, the sum on deposit in this escrow-type interest-bearing account amounted to over $2.8 billion).

A third category of Saudi Arabian military financial flows derives from the Kingdom's practice of guaranteeing payments for other foreign customers which participate in the foreign military sales programme. As of 30 September 1979, for example, Saudi Arabia had guaranteed payments worth over $680 million in respect of sales agreements signed with Jordan and Yemen, and Treasury trust fund balances for those two countries amounted to $145 million and $137 million respectively. At the same date, Saudi Arabia held about $1.9 billion in its military trust fund at the Treasury, while a further $1.4 billion was maintained on deposit under the long-standing letter-of-credit arrangements with Chase Manhattan Bank.

* * *

ROLE OF THE US ARMY CORPS OF ENGINEERS

The US Army Corps of Engineers' first construction project in Saudi Arabia was a US-funded airfield at Dhahran, completed in 1954. In April 1957, after Saudi Arabia had indicated its support of the Eisenhower Doctrine, which had pledged US support to any Middle East country threatened by Communism, the United States and Saudi Arabia signed an agreement whereby Saudi Arabia undertook to renew the base rights agreement for Dhahran airfield until 1962; while America agreed to provide training and equipment for Saudi Arabia's forces, and to improve civilian air facilities at Dhahran. A Corps area office was established at Dhahran to monitor the construction work, which was completed in 1961.

In the 1960s, the Saudi Arabian Ministry of Information asked to use the Corps' services to construct television and radio facilities. The first project, which implemented a December 1963 government-to-government agreement, called for the design and construction of two temporary television stations. Later, the Corps built a radio station facility for the Saudi Ministry of Information.

Shortly after the Corps had begun work on that television contract, the Saudi Government requested help on military projects already under way. A diplomatic agreement covering the construction of military facilities - known as the Engineer Assistance Agreement, mentioned earlier - was signed on 24 May 1965. This has provided the backbone of the US Army Corps of Engineers' involvement in Saudi Arabia ever since. Under that Agreement, the Corps is authorised to provide complete engineering and construction management facilities for the design and construction of specified Saudi military requirements. An enormous project, well advanced or perhaps completed, involves a military cantonment to accommodate, in the words of an official US document, 'three Saudi army brigades and 51,000 people'.

After 1972, Saudi Arabia became a substantial purchaser of US military hardware and related training and support services. In addition, the US Army Corps of Engineers expanded its provision of management services for large-scale military construction projects. Most Saudi purchases have taken the form of cash transactions handled by the US Department of Defense under the Foreign Military Sales Act of 1968, subsequently redesignated the Arms Export Control Act.

The Army Corps of Engineers agreed to supervise and manage more than $5.2 billion of construction facilities between fiscal 1970 and 30 September 1976. Not all of this work was undertaken under Foreign Military Sales procedures. Prior to 1 December 1975, the Corps accepted a number of contracts from the Saudis by means of letters and independent agreements outside the auspices of the Department of Defense's directives. Additionally, Saudi Arabia ordered more than $71 million worth of military hardware directly from US commercial sources between 1970 and 1975.

Since 1972, accumulated sales orders placed by Saudi Arabia through the US military authorities have expanded dramatically, although deliveries have not kept pace. Between 1966 and 1972, undelivered orders averaged $3.5 billion per annum; but by 1976, they were running at $10.4 billion. Undelivered orders have exceeded deliveries due to a number of factors - notably the increasing volume of military orders being processed, the extended time period involved in furnishing construction services, and the nature of the items ordered (especially sophisticated missiles, artillery, tanks and other armoured vehicles). Deliveries have frequently been made between two and five years after the placement of orders. Interestingly, the Egyptian government has also been urging the United States to fulfil its military

Grants/sales	$ billion
'Given away'[1]:	61.8
of which:	
Military Assistance Program[2]	53.5
Excess defence articles	6.4
Training services	1.9
Sold:	92.8
of which:	
Foreign Military Sales agreements:[3]	
Sold for cash	70.4
Sold on credit[4]	14.2
Commercial deliveries[5]	8.2
Total:	154.6

Table 15: Total reported (i.e. 'open') US grants and sales of military equipment and services, 1950-78, in billions of US dollars. Notes: 1: excludes loan and lease of naval vessels and cash grants under the Security Supporting Assistance Program; 2: includes military assistance to countries involved in the Vietnam War that was funded through Defense Department appropriations; 3: only $41.0 billion of the $84.6 billion in FMS cash and credit sales had been delivered by May 1979; 4: covers fiscal years 1955-78; 5: available data covers only fiscal years 1960-78.

Source: General Accounting Office.

delivery commitments, which have been running increasingly behind schedule.

In addition to its 'normal' functions in the Kingdom, the Corps has been assisting Saudi Arabia in the development of a modern logistics system for its Army Ordnance Corps. Diplomatic agreements between the United States and Saudi Arabia were signed on 7 September 1966 and 17 October 1967, to provide vehicles, a supply system for vehicle and conventional armament spare parts, and training - all on a reimbursible basis. The Corps was selected to manage this five-year programme after the US Army Materiel Command (subsequently renamed the US Army Materiel Development and Readiness Command), and the US Military Training Mission, based in Saudi Arabia since the early 1950s, had indicated their unwillingness to undertake this extra work.

The total cost of that particular programme was $146.7 million, of which $49 million was spent on vehicles, weapons and spare parts. By 1972, the Saudi Ordnance Corps had developed a system for obtaining spare parts and fully equipped maintenance facilities. For various reasons, however, the Saudi Corps was evidently not prepared to assume full management of the newly established logistics system - particularly in respect of contracting and control of funds.

In 1972, therefore, a new two-year arrangement was specified, which provided for the Corps to assist the Saudi Ordnance Corps with a personal services contract. Duties included the administration of the personal services contract and training in planning, budgeting and contract administration and supervision. The total cost of this operation came to $131.6 million. The contract was renewed to November 1976, and subsequently. Between 1974 and 1977, total expenditure under this contract amounted to $444.2 million, bringing the aggregate value of the Saudi Ordnance Corps development programme to $722.5 billion.

In addition to the activities mentioned, the US Army Corps of Engineers' design and construction activities have also included the provision of living accommodation for the National Guard modernisation programme, together with various projects for the Ministry of Defense and Aviation - including the construction of water wells at Al-Batin, Riyadh and Tabuq; additions to the military cantonments at Tabuq and Khamis Mushayt; the construction of an officer's club at Riyadh; the provision of fencing at Al-Batin, family housing at Tabuq and medical support facilities at Khamis Mushayt, Tabuq and Jeddah; and the establishment of a museum and library at Riyadh.

In June 1975, the US Joint Chiefs of Staff and the Deputy Secretary of Defense of the day directed that responsibility for the Saudi Ordnance Corps programme should be transferred from the Corps of Engineers to the US Military Training Mission. However a Saudi Arabian official objected to this transfer, and the US Army Corps has continued to manage the scheme. As of 30 August 1976, the Corps was managing 33 construction contracts valued at $1.2 billion. US contractors were handling 7 of these contracts (21%), valued at $673 million, or 56% of the total contract value[82].

* * *

INDEFINITE US MILITARY INVOLVEMENT IN PROSPECT

An official source has summed up the United States' military involvement in Saudi Arabia in the following terms: 'In view of Saudi Arabia's future military construction plans, US Army Corps of Engineers presence in Saudi Arabia will probably continue *for an undeterminable number of years*. Its rôle contributes to bringing good relations with the Saudi Arabian Government, as well as providing opportunities for American business firms'[83].

In this connection, it is interesting that the report of the Senate Committee on the Budget to accompany the Omnibus Reconciliation Act of 1981[84], containing a submission by the Committee on Environment and Public Works, which has oversight over the activities of the US Army Corps of Engineers, identifies the financially privileged position of the Corps. According to the Committee, the US Army Corps of Engineers ''program' is unusual, as it has never been based upon an annual authorization level. Rather, there is a universe of authorized, but unfunded; work which now approaches $50 billion'. Since, of course, the Corps specialises in heavy construction activity, it is possible that a proportion of profitable earnings derived from extensive, reimbursed military construction activity in Saudi Arabia, may be ''rolled over' to finance construction activity in the United States.

For completeness' sake, it should be added that a separate programme involves the modernisation of the Saudi Arabian National Guard - a volunteer military organisation which is wholly distinct from the Saudi Arabian Ministry of Defense and Aviation. The National Guard's purpose is said to be to provide internal security for the Kingdom, under the command of Prince Abdullah Ibn Abdul Aziz Al-Saud. Interestingly, because of the National Guard's separate status, the Saudis insisted that the US involvement with the National Guard should be independent of the US Military Training Mission and other activities. Moreover the Guard was excluded from earlier US studies of Saudi Arabia's defence requirements. The modernisation scheme began in March 1973, with the signing of a United States-Saudi Arabian memorandum of understanding. This agreement had been preceded by Saudi requests for such a programme, dating back to 1970. The National Guard modernisation programme was scheduled for completion by January 1980.

Its purpose had been to convert part of the standing National Guard forces into mechanised infantry battalions with artillery. Accomplished by three US contractors, the programme included the sale of US and foreign equipment, contractor training, construction and contractor-performed maintenance, and supply support. The scheme has since been expanded to incorporate training of National Guard headquarters personnel in management techniques, and provision for specialised US teams to accompany deployed battalions in the field.

Considered a mobile reserve force for the Saudi Army, but being concerned mainly with internal security, the National Guard has not been equipped as a front-line combat element. The main combat vehicle purchased by the National Guard is the V-150 armoured vehicle, and modernisation projects managed by the United States had not included the supply of tanks up to the end of 1977. In 1976, it was estimated that the total value of the National Guard modernisation programme would amount to $1,853,900,000. Substantial upward cost revisions are thought to have been made.

A particularly interesting sidelight on all this is that the 'dual army' system in Saudi Arabia has been paralleled by a degree of duplication on the US side. It has already been pointed out that (for internal security reasons) the Saudi Arabian National Guard would have nothing to do with the US Military Training Mission which was handling and supervising the work, for example, of the US Army Corps of Engineers. Accordingly, in April 1973, the US Army Materiel Development and Readiness Command (DARCOM) was assigned general management responsibility for the modernisation of the Saudi Arabian National Guard.

Specifically, a project manager's office was established in Saudi Arabia with an initial staff of 53 and a Washington-based staff of 4, all of whom were involved in monitoring and administering the work of the three contractors involved. These were *General Electric*, which sells, maintains and trains personnel connected with its Vulcan anti-aircraft battery system; *Cadillac-Gage*, which provides armoured support services to the Saudi Arabian National Guard (notably the V-150 armoured personnel carrier); and the *Vinnell Corporation*, well known among observers as a US Government military front organisation which masquerades as a commercial enterprise - and which, in this case, provides overall equipment and tactical training, including operation, maintenance and supply training for the Vulcan and V-150 armoured personnel carrier. This corporation is also responsible, under the direction of a former US Defense Security Assistance Agency official, for day-to-day management of the Saudi Arabian National Guard modernisation programme.

By September 1977, four separate organisations from the US Department of Defense were involved in Saudi Arabia, involving 912 military and civilian personnel. These were managing the US Military Training Mission - which has overall responsibility for modernising the 49,000-strong Saudi armed forces apart from the Saudi Arabian National Guard - together with the US Army Corps of Engineers Middle East Division, US Air Force Detachment 22, and a US Army Materiel Development and Readiness Command project office. Additionally, over 2,900 US contractor personnel were operating in the country - providing training and services under specific agreements or commercial contracts. Large increases in US Government and contractor personnel have since been reported. In September 1977, training for naval operations, maintenance and supply activities was being provided for about 3,500 enlisted Saudi Arabian personnel and 400 officers. Mr Bergsten is on record as having estimated in 1977 that there were at least 30,000 US nationals in Saudi Arabia, but the total is certainly much higher today. No data are available on the total number of US nationals who are engaged in military-related activities.

Naval construction activity managed by the US military has included the development of port facilities (under the Saudi Naval Expansion Program, or SNEP) at Jubail on the Persian Gulf, and at Jeddah on the Red Sea coast - involving the provision of facilities for ship docking and repair, fuel storage, base maintenance, administrative functions and living accommodation, and a naval headquarters complex in Riyadh. All this had involved expenditure of about $2,678,000,000 by 1977 - with ships and total costs of the associated facilities mentioned having risen from $850 million in 1974. Some of these cost increases had reflected expenditure on missile patrol gunboats (which rose from $235 million to $511 million over the period), missile patrol chasers (from $148 million to $333 million), and miscellaneous construction costs - which soared from $364 million to $1.7 billion.

Other important projects involving the US military in the Kingdom, and financed with Saudi petrodollars, have included the 'Peace Hawk Program', recommended following a Department of Defense study in 1970 urging Saudi Arabia to replace its F-86 and T-33 aircraft; and an army modernisation programme to mechanise certain Saudi infantry brigades. In 1977, the estimated cost of that particular scheme was $6,632 million. In the late 1970s, the Saudis were purchasing a wide range of US military equipment - including M60A1 tanks, armoured personnel carriers, M10/125 mortar carriers, M109-A1B Howitzers, M577A1 command carriers, M548 cargo carriers, M163 Vulcan anti-aircraft systems, M578 light recovery vehicles, TOW system launchers with missiles, and 'redeyes'.

The US Military Training Mission, operating under the Mutual Defense Assistance Act of 27 June 1953, has provided continuing advice and military aid to the Saudi Arabian Government over the years. Building on this long-established background of military cooperation, the United States concluded a parallel agreement with Saudi Arabia in 1974, to establish a Joint Military Commission. Details of the activities of this commission have never been divulged. In 1977, an exchange of notes between Washington and Riyadh defined the remit of a US security assistance group - specifying that the group would be responsible for planning, organising, training, logistics, supply, the provision of studies and recommendations requested by Saudi armed forces officials or requested by the US military training mission - and administration of the overall US military cooperation programme with Saudi Arabia. All this activity supports the United States' long-term strategic and economic objectives. Indeed the petrodollar-recycling purposes of the Foreign Military Sales and associated programs have been officially clarified in terms which demonstrate the overwhelming economic pressures now being exerted by the US military-industrial complex. In addition to the overriding objectives of encouraging the expenditure of petrodollars with US business firms and enticing large volumes of such liquidity into US official debt, the General Accounting Office has stressed[85] that 'benefits of the Foreign Military Sales Program that are often mentioned as accruing to the United States' and which derive from the Arms Export Control Act of 30 June 1976 (amending the Foreign Military Sales Act) include 'assisting the US balance-of-payments', sharing research and development costs, reducing costs incurred by the US military services, increasing US employment, and keeping US military production bases active.

The magnitude of the export and transfer activity of the US military-industrial complex is illustrated in Table 15. Over the 28 years 1950-78, the total value of US military equipment disposed of by way of grants or sales amounted to $154.6 billion. Of this total, equipment worth $61.8 billion was 'given away'. About $44 billion worth of armaments and related items remained undelivered at the end of 1978. Some 78 naval vessels were on loan or lease to foreign countries. The transfers component of the total, which did not take account of any military sales cancelled due to events in Iran during 1978 and 1979, included, in addition to weapons, support equipment, training, spare parts, vehicles and construction activity. The grant component has had to be paid for somehow[86].

In the late 1940s and throughout the 1950s, US public arms exports were financed with appropriated funds, and almost exclusively furnished as grant military assistance (that is, 'given away'). In the mid-1960s, appropriations for such grants were significantly reduced. To some extent, the Executive Branch offset the reduced grant programmes by making increased arms available through a system of 'excess defence articles' distribution, for which prior legislative authorisation was not required. At the same time, as economies in Europe recovered, and needed to replace the armaments 'given' them a decade earlier, they were persuaded by the United States that they could afford to purchase US arms - especially in the context of offsetting the United States' cost of maintaining forces in their countries. US arms sales exceeded arms grants for the first time in fiscal 1964. The vigorous competition for sales among the world's arms suppliers first emerged at around that time, as the old colonial empires disintegrated.

The Department of Defense was no laggard when it came to merchandising death products. Credit agreements were reached, to facilitate sales. Direct loans and loan guarantees were arranged by the government. Up to 1978, more than $14 billion of arms sales had been financed by the US Government, of which about $8 billion had represented loans to Israel. With the escalation of oil prices in 1974, a huge new market for US armaments opened up among the OPEC countries. In the words of the General Accounting Office, 'in the developing world, the oil-producing nations received increased revenues from rising petroleum prices hence... US arms transfers represented cash sales'.

* * *

MILITARY SALES THROUGH THE FEDERAL FINANCING BANK

The question of how non-reimbursed military assistance is financed connects with a worrying feature of the foreign military-industrial juggernaut: the increasing use of finance provided by the Federal Financing Bank, an off-budget entity of the Treasury, which 'borrows' from the Treasury and thus exerts continuing upward pressure on the statutory debt ceiling. The farcical spectacle of Treasury officials going through the charade of requesting Congress to approve an increase in the statutory debt ceiling to accommodate 'unanticipated', but committed, increases in Federal sector spending, reflects the inexorable momentum of uncontrolled on- and off-budget outlays - not least, the extraordinary arrangement whereby, under the Federal Financing Bank Act of 1973, the Treasury Secretary is required to respond positively to the importunate demands of government departments or agencies which require 'top-up' liquidity because of their chronic over-spending[87].

Significantly, the first draft of this legislation, introduced in the Senate on 13 December 1971, encapsulated the new permissive attitude and intentions of its authors. Section 2 begins: 'The Congress finds that demands for funds through Federal and federally-assisted borrowing programs are increasing faster than the total supply of credit'[88]. Thus, barely four months after George Schultz had reported that the US Government was now free 'to follow the domestic policies that we feel are the important ones', critical legislation was being promoted which would greatly facilitate that process. The inflationary Federal Financing Bank arrangements, and the entire loan guarantee system, are wholly inconsistent with monetary and fiscal policy aimed at economic stabilisation.

For this reason, it is particularly disturbing that Congress has just instructed the Treasury to establish a Strategic Petroleum Reserve Account at the Treasury, which the Treasury Secretary is directed to 'provide' with $21.9 billion. It is all the more worrying that 'the receipts, obligations, and outlays created by such transactions shall be presented annually in the Budget of the United States Government, *but shall not be included in the totals of the budget and shall be exempt from any general limitation imposed by statute on expenditures (budget outlays) of the United States*'[89]. This blatant acceptance of the dubious principle of 'off-off budget' financing, which will not be counted within the statutory debt ceiling, seems to eliminate, once and for all, any prospect that the headlong expansion of permissive Federal deficit funding activity is likely to be curbed.

Against this background, the use of the Federal Financing Bank to finance foreign military assistance since 1975 is all the more a matter for concern. In 1967, the Foreign Assistance Act terminated an existing revolving fund approach to such financing[90]. But the Foreign Military Sales Act of 1968 again authorised the President to provide direct loans to finance foreign military sales, and specified that repayment of the loans should be made within ten years following delivery[91]. Prior to the formation of the Federal Financing Bank, the Department of Defense funded foreign military credit sales entirely with loan guarantees and on-budget appropriations. Indeed, according to the Acting Director of the Defense Security Assistance Agency, the Department of Defense had 'never borrowed money from private market sources, nor sold debt obligations pertaining to this program (of foreign military credit sales) to private investors'[92]. Loans guaranteed by the Department of Defense were provided by private US commercial banks[93].

The Department did not begin making use of the Federal Financing Bank until February 1975, when the Bank started purchasing the fully-guaranteed loans which were the subject of Department of Defense commitments following an agreement reached on 3 February[94]. Under this arrangement, the Federal Financing Bank agreed to purchase up to $600 million of Department of Defense guaranteed notes issued by foreign borrowers. By 30 June 1976, this total had been increased to $1,543 million, to accommodate the growing level of foreign military credit sales.

The substitution of the Federal Financing Bank for private banks went unnoticed, because of course the Federal Financing Bank operates off-budget. The Bank's practice of purchasing Department of Defense-guaranteed notes issued by foreign borrowers quickly became established, with notes in the names of the governments of Turkey, Greece, Brazil and China worth $117.7 million being purchased in the final months of fiscal 1975; and purchases covering 102 separate transactions, worth $802.8 million, being contracted for in fiscal 1976 - on behalf of the governments of China, Greece, Brazil, the Philippines, Korea, Argentina, Indonesia, Israel, Peru, Morocco, Uruguay, Guatemala, Nicaragua and Jordan[95]. Mr Roland H Cook, Secretary of the Federal Financing Bank, wrote on 26 April 1977 that 'repayments are generally made over a seven-year period. However, some repayment schedules range from as short as four years to as long as thirty years, as in the case of Israel'[96].

Substantial military supplies to Egypt, under a far-reaching five-year military agreement reached between the United States and that country in April 1981, are being financed, in part, through the Federal Financing Bank. For fiscal 1982 alone, the Department of Defense proposed earlier this year a foreign military sales programme for Egypt worth $900 million[97]. President Sadat has invited the United States to construct military bases 'for the Egyptian Army' and to station an unlimited number of US troops in Egypt 'in the event of any threat to Saudi Arabia'. Since, patently, a threat to Saudi Arabia is a permanent feature of the geopolitical landscape, these Egyptian official statements are among a number which can be interpreted as providing confirmation of an intention that the US-Egyptian military axis should become of comparable political weight to that with Saudi Arabia. The Egyptians have, indeed, been seeking to equate their importance with that of Israel and Saudi Arabia in Washington's eyes. So there will clearly be plenty of work for the Corps of Engineers - improving and expanding the R'as Banas, Qeha and Cairo West bases, for example. Significantly, the Middle East News Agency revealed on 23 March 1980 that the Egyptian weekly news magazine *'As-Siyasi'* intended to reveal that huge oil deposits (consisting of 5,000 million barrels) had been discovered in Egypt's Western desert area.

So the overall strategy whereby the ever-expanding 'export' operations of the United States' military-industrial complex are being financed, and will have to be financed in the future, is plain. As long as the vast lake of petroliquidity never runs dry, this extremely dangerous bonanza can presumably continue. As the numbers balloon, however, so will the anomalies, the corruption, the blurring of objectives - and the weight of geofinancial, national, commercial, banking and vested interest in the indefinite perpetuation of the globally inflationary petrodollar system.

* * *

EASY COME, EASY GO AT DEPARTMENT OF DEFENSE

Extraordinary anomalies or 'inconsistencies' are nowadays reported as a matter of routine in connection with the transactions of the Department of Defense. For fiscal 1977, for example, the General Accounting Office identified $1.1 billion of 'accounting errors'. The review was requested by Congressman Lee H Hamilton on 16 November 1977, after the Defense Security Assistance Agency had disclosed that its previously reported 1977 foreign military sales estimate of $9.9 billion, had been underestimated by $1.4 billion (see Table 16). Of this total, 'about $133 million of the adjustment was misclassified... pertaining to construction work administered by the Army Corps of Engineers in Saudi Arabia'[98].

Providing a useful insight into the sheer scale of US military construction activity conducted by the Corps in Saudi Arabia, the General Accounting Office report which drew attention to these anomalies noted that '...administrative charges amounted to about $280 million, and the construction program, primarily for Saudi Arabia, amounted to about $470 million, and includes the design and construction of naval port facilities, military air bases, infantry and artillery centers, family housing and medical facilities. The US does not do any actual construction, *but rather provides management services which are roughly 10% of the program*'.

Two months later, the Comptroller-General's Office reported that the Defense

	Defense Security Assistance Agency	Adjusted for accounting inconsistencies and errors found by GAO	Differences
Value of fiscal 1977 sales pertaining to items and services covered by the ceiling	8,769	8,342	427
Sales adjusted for inflation from fiscal 1977 to fiscal 1978	9,295	8,843	452
Fiscal 1978 arms sales ceiling	8,600	8,180	420

Table 16: Overstatement of the Defense Security Assistance Agency's calculation of the fiscal 1978 arms sales ceiling, in millions of dollars.

Source: General Accounting Office.

Security Assistance Agency was suffering from an 'inability to accurately account for the value of foreign military sales'. This inability had resulted in over $2 billion of accounting errors, inconsistencies and differences which may have caused the President's arms sales ceiling to be set $420 million higher than it otherwise would have been[99].

In the 24 July 1978 issue of *Business Week*, a high-ranking Defense official charged that the Department of Defense had lost financial control of the programme. Specifically, he said that the Department lacked information concerning the financial status of arms sales and could not tell foreign governments precisely what had been done with their money, or whether they had been accurately billed. At around the same time, the General Accounting Office noted that disbursements made by the military departments on behalf of foreign customers are not always reported to the Denver Center in sufficient detail to permit any proper accounting to foreign countries on how their funds were spent. For example, the Navy disbursed foreign funds amounting to over $2 billion, for which it had identified the country and sales agreements involved, but had failed to identify the specific articles and services paid for out of these funds.

Moreover the US Navy has, in the past, apparently been unaware of the true level of the balance at its trust fund account with the Treasury. At 1 June 1978, for example, the Navy's cash balance at the Treasury was said to be $876.4 million; whereas cash balances on individual sales case accounting records at the Denver Accounting Center amounted to $1,430.9 million - a difference of $554.5 million[100]. Either the accountants at Denver were in a muddle, or there was something wrong with the Treasury's record-keeping arrangements. The Navy apparently spent thousands of staffdays trying to account for these missing funds - evidently without success.

There is dissatisfaction in some quarters at the Treasury's accounting efficiency. Thus the Trust and Revolving Funds Branch of the Treasury has been criticised recently for failing to keep adequate records and filing systems in connection with the operations of the Federal Financing Bank. There was said to be no accounting manual, inadequate records of investment policies or procedures, little documentation showing what accounting methods are used, and an outdated filing system[101]. Records were 'maintained in folders and stored in file cabinets... The bank's filing system may no longer enhance Bank operations', having been designed when the Bank 'opened its doors' in 1974. Its holdings now exceed $90 billion, and the General

Accounting Office felt that the Bank 'needs to prevent the system from becoming so overwhelmed that records are inaccurate or inaccessible'. And the auditors added:

'The Bank also needs to improve its recordkeeping practices. Interest memorandums are not always kept in the same place or in good chronological order. Supporting documentation for journal vouchers is not always in the correct location. Records of administrative expenses are out of date because Treasury personnel do not submit expenses on time and the accounting staff does not follow up'. The auditors also found that they had to spend far too much time verifying the existence of promissory notes, interest memoranda, journal vouchers and support for transfers of funds to and from the Bank. There was no clear audit trail. In addition to controlling the Federal Financing Bank's accounting function, the Trust and Revolving Funds Branch was responsible for '<u>seven major trust funds</u>' and suffered from a high staff turnover, inadequate staffing and the absence of accounting system documentation. All this led to 'unnecessary inefficiency'.

If the staff running the Federal Financing Bank - which, despite its convenience to the Treasury, facilitates the headlong deficit-financing operations of the Federal Government and is therefore inherently detrimental to budgetary discipline - cannot even keep its own records in good order, what confidence should we have in the stewardship of the 'seven major trust funds' for which they are also responsible? As has been demonstrated, questions need to be answered about some of these trust funds. The knowledge that they may not be efficiently managed, makes it all the more urgent for a full inventory of flows of funds through all Treasury trust funds - especially those handling inflows from abroad - to be made available for Congressional scrutiny.

* * *

DEFENCE OF SAUDI ARABIA = DEFENCE OF DOLLAR SYSTEM

This survey of some of the many uncertainties which surround petroliquidity flows should be sufficient to convince the most determined analysts that attempts to quantify what is happening to OPEC funds, and the size of the investible surplus, are probably a waste of time. As the petroleum-driven monetary expansion continues, the numbers balloon to colossal proportions, more and more surplus liquidity is siphoned into 'commissions', the underground economy, corruption and military-industrial transactions, it will make less and less sense to seek to identify what is happening to all this depreciating paper money. The avalanche of inflationary dollar liquidity has reproduced itself by more than a factor of ten since George Schultz first rejoiced at the US Government's new freedom to print money and overspend, back in August 1971.

No doubt George Schultz, like Paul Volcker, was a prime mover in persuading Congress to allow the Treasury to establish the Federal Financing Bank. What is clear is that this institution jeopardises the prerogative of Congress to consider expenditure plans before Federal spending commitments have been made - because the whole point of the Federal Financing Bank is, in fact, to validate excess expenditure. This, of course, is vehemently denied by senior Treasury officials[102], who object to the Federal Financing Bank being treated as a scapegoat for government overspending; but they protest too loudly.

On the contrary, officials may well have taken the view in the past that the United States' ability to attract petrodollars back to the US financial system - and, notably, the success of the Treasury in enticing petrofunds into official and quasi-official securities, and the Defense Department's rapidly expanding military sales campaign to generate large financial flows to the US military-industrial complex - entitled them to take a reasonably sanguine view of budgetary overspending. While off-budget outlays constantly raised the statutory debt ceiling and undermined the effectiveness of residual Congressional spending oversight efforts, ample supplies of newly-generated petroliquidity would remain forthcoming, to finance the Federal sector's ballooning deficits, and to assure a continuing stream of lucrative military sales contracts. 'Structural' domestic financial permissiveness in the public sector, and the expansion of the global dollar money supply to finance the higher cartelised oil prices, may have been seen as complementary phenomena; which is exactly what they are.

Yet little imagination is needed to envisage the serious difficulties which might overwhelm the Federal sector's finances in the event of the oil price ceasing to perform its apparent function as the underlying engine of world dollar inflation. Nor does one require a Nobel prize in economics to perceive the consequences of such a development for the international flow-of-funds, and thus for many large eurobanks which have long since abandoned prudential lending criteria and have irresponsibly based their assessments for the future on the complacent expectation that this petro-inflation must continue indefinitely.

Such considerations devalue, in my opinion, the usefulness of efforts to quantify OPEC current and investible surpluses. It is, however, clear that elaborate calculations to this end perform a necessary psychological function - namely, to reassure the international financial community that petrodollar liquidity will continue to multiply, as it has these past ten years, so that at least the banks will remain prosperous. With the greatest respect, this Subcommittee's drive to quantify the size, scope for expansion and disposition of OPEC investment in the US financial system and economy seems to beg the question of what on earth the United States would do <u>without</u> such investment. Having set the ball rolling - and having appeased the petroleum monopolists - the United States has done well out of this bonanza. As Sharif Ghalib has correctly pointed out[103], 'the US gets the oil money back' - *exactly* as the Treasury intended.

It's too late now to worry about the Arabs coming to own uncomfortably large portfolios of US financial and other assets. There's no way of stopping this process continuing, without pulling the house down. Invoking the International Emergency Economic Powers Act to freeze Saudi Arabian financial assets is certainly an option that has been proposed, as has been shown; and it could well be resorted to in extreme circumstances - that is to say, if the Saudi Arabian régime were overthrown and replaced by a radical group, or the Kingdom were engulfed in turmoil. It is sufficiently clear from the documented extent of US military activity in and around the Arabian Peninsula, and from European intelligence sources I have consulted, that Washington draws the line over Saudi Arabia.

There is little doubt that America would go to war to preserve Saudi Arabia - which is presumably what Mr James E Akins meant on a British television programme recently when he reiterated that the Saudi Arabian Government was the most stable in the Middle East. Everyone knows this is rubbish; but what the former Ambassador intended to convey was that, in defending Saudi Arabia, the United States is defending not only its access to prolific supplies of petroleum (even though it needs Saudi oil less and less), but <u>the entire fragile structure of the petrodollar financial system</u>. The Soviet Union understands perfectly well that this financial house of cards is highly vulnerable. 'Early this year', a Senate Committee on Energy and Natural Resources staff report noted last December[104], 'the Soviets proposed an all-European Conference on Energy that would include the USSR but not the United States. They have let it be known that they are eager to explore new forms of anti-Western solidarity with members of the Organization of Arab Petroleum

Exporting Countries *and have suggested that Arab oil revenues be withdrawn from Western banks'.*

* * *

OPEC WEALTH ACCORDING TO THE RESPECTED SOURCES

Geofinancial and geopolitical considerations apart, conventional estimates and projections of OPEC's current and investible surplus by the Bank of England, Morgan Guaranty Trust Company, the Bank for International Settlements and the US Treasury are remarkably close. They probably sidestep considerations of leakages, under-reported and 'hidden' flows of funds such as those documented in this survey; and to this extent, their accuracy is open to question. Table 17 gives two series for the current account surplus of the OPEC countries. The first, taken from a Morgan Guaranty Trust Company source, shows the current surplus from 1975-80 together with a projection for 1981-85. It takes account of the latest revisions contained in *World Financial Markets*. Morgan Guaranty also calculate that by the end of 1985, the accumulated external assets of the OPEC countries will aggregate $550 billion. This, of course, takes no account of market value changes in any securities that may be held. The Bank of England's estimate of the OPEC current account surplus is similar to Morgan Guaranty's, and the small discrepancy shown is attributable to the fact that the Bank of England incorporates figures not only for the 13 OPEC countries, but also for Bahrain, Oman, Brunei and Trinidad and Tobago.

The Bank of England also has a series which is awkwardly labelled 'net external borrowing etc'. This is an amalgam of gross borrowings on international markets net of repayments, inward direct investment and changes in credit given for oil exports. This series, with the current surplus, gives the surplus available for investment. Net borrowing is the largest element in this series, which swung between +$20 billion and -$11 billion between 1978 and 1980. Some OPEC countries have, of course, been heavy borrowers in recent years; OPEC's gross syndicated credits exceeded $10 billion in each of the years 1978-80. Indeed, in 1978, when the current surplus all but disappeared, there would have been no investible surplus, but for borrowing.

The Bank of England's calculations of how the investible surplus was placed, are summarised in Table 18. In 1975-76, all investment outlets were successfully identified; but in 1977-80 there was a significant proportion which could not be positively identified, ranging up to $10 billion in 1979. Some $14 billion ($4.3%) was loaned to international organisations in 1974-80, out of total OPEC identified investments aggregating $324 billion. Of the

$67 billion invested in the United Kingdom during that seven-year period, $55 billion (82%) took the form of foreign currency deposits with commercial banks. The remaining $12 billion was distributed between government stocks, sterling bank deposits, Treasury bills, equities and property.

The figures suggest that only $65 billion (21% of the grand total), was invested in the United States - and that, of this total, only a net $24 billion was deposited in Treasury securities of all kinds during the period covered. At first sight, this might seem to contradict the thrust of the argument in this survey, and the familiar contention that since OPEC insists on being paid in dollars and New York offers the widest range of financial instruments, OPEC countries with surplus funds have little choice but to purchase official US paper in volume. In practice, the Treasury's 'add-on' system for selling additional unannounced tranches of Treasury paper, together with flows of funds into military trust accounts and via huge military sales and construction contracts, need to be taken into account when trying to assess the aggregate flow of OPEC funds into the Treasury. At the end of March 1981, the Treasury claimed that OPEC investments in US Treasury bills and Certificates amounted to just $8.2 billion, while OPEC holdings of Treasury bonds and notes aggregated $19.3 billion. Quite apart from the probability that these figures are understated, they take no account of moneys in trust funds and petroliquidity channelled into the securities of government-sponsored enterprises such as Fannie Mae. In any case, in view of the many uncertainties mentioned in this investigation, and the Treasury's presumed interest in disguising the true level of OPEC investments in the US financial system (in deference to OPEC sensitivities about disclosure and the Arab need for confidentiality), such figures ought, at the very least, to be treated with caution. Of the remaining $41 billion invested in the United States, a little over 25% went into deposits with commercial banks during the period reviewed. A much larger segment appears to have found its way into corporate bonds, stocks and property holdings. At the same time, $178 billion (57% of the grand total) was evidently invested in countries other than the United States and the United Kingdom, with $79 billion of this amount being held in bank deposits. This sum, combined with the $55 billion deposited in foreign currencies in London, implies that $134 billion (43%) of OPEC invested funds were held in the euromarkets - mainly in dollars, in view of the fact that, according to Morgan Guaranty Trust Company, about 75% of the gross euromarket is denominated in dollars.

Finally, $99 billion is said to have been lent to developed and underdeveloped countries, and placed in the stock markets of the developed economies. Only during the past two years, as Table 18 shows, are OPEC investments broken down between developed countries and the Third World. It is unfortunate that the split could not be run back one further year, since it might have provided evidence that OPEC loans to Less Developed Countries bear little relation to their ability to repay. Thus in 1978, when the current surplus had almost vanished, such loans may well have been maintained; while in 1980, when the current surplus was in three figures, they fell from the previous year's total. Conversely, loans to developed countries last year doubled. This reflected the positive Arab response to the blandishments of German and Japanese official missions to the Gulf in search of massive balance-of-payments placements. Indeed the Bundesbank believes that in 1980 'Germany's current account vis-à-vis the OPEC countries was financed in full by additional investment in Germany by those countries'[105]. This was chiefly due to the West German public authorities' heavy borrowing operations in the OPEC countries, and also to substantial OPEC investments in German equities.

The most interesting feature of Table 19, taken from US Treasury Department data prepared on 29 June 1981, is the accumulated investible surplus discrepancy of $37.8 billion monitored in 1974-80. As the table shows, this has increased sharply in recent years - jumping from $0.8 billion in 1977 to $14.5 billion in 1980. The mismatch may well reflect some of the discrepancies and anomalies discussed. In 1981, a much larger discrepancy in the investible

Year	Morgan Guaranty Trust Company		Bank of England[3]		
	Current surplus[1]	External assets	Current surplus[1]	Net external borrowing[2]	Investible surplus
1973	5	9			
1974	64	73			
1975	30	103	31	4	35
1976	34	137	36	2	38
1977	24	161	27	11	38
1978	1	162	- 1	20	19
1979	62	224	66	5	71
1980	103	327	106	-11	95
1981	88	415			
1982	60	475			
1983	40	575			
1984	25	540			
1985	10	550			

Table 17: Estimates of OPEC's current surplus and the surplus available for investment, with total external assets, in billions of US dollars. Notes: [1]Including transfers; [2]Net borrowing, inward direct investment and changes in credit given for oil exports; [3]Data includes Bahrain, Brunei, Oman, Trinidad and Tobago.

Sources: Morgan Guaranty Trust Company; Bank of England.

Location type of deposit	1974	1975	1976	1977	1978	1979	1980	1974-1980
United Kingdom: foreign currency deposits	14	4	6	3	- 2	15	15	55
United Kingdom: other	7	-	- 1	1	-	2	3	12
United States: Treasury bills, notes, bonds	6	3	3	3	- 3	2	10	24
United States: other (mainly equities, property)	5	7	9	6	4	5	5	41
Other countries: bank deposits	9	5	7	8	5	19	26	79
Loans to LDCs						10	7)	
Equities and loans to DCs	12	12	12	13	9	8	16)	99
Subtotal:	53	31	36	34	13	61	82	310
International organisations	3	4	2	-	-	-	5	14
Total:	56	35	38	34	13	61	87	324
Unidentified residual		-	4	4	6	10	8	
Investible surplus		35	38	38	19	71	95	

Table 18: Disposition of OPEC's investible surplus, according to the Bank of England, in billions of US dollars.

Source: Bank of England.

surplus is likely to eventuate - if only because emergency finance, thought to have been of the order of $9.5 billion, was diverted to Iraq by Saudi Arabia, Kuwait, the United Arab Emirates and Qatar earlier this year[106], following urgent representations from Baghdad.

The first indication that Iraq was seeking huge financial assistance from its neighbours emerged in April, when usually reliable Kuwaiti sources reported that, between them, Saudi Arabia and Kuwait had agreed to furnish Iraq with $6 billion. Of that total, Saudi Arabia was to provide $4 billion and Kuwait $2 billion. Additional amounts were also to be provided from other sources. The interest-free Kuwaiti portion of the loan, reviewed by the newly-reconstituted Kuwait National Assembly in mid-April, was to be employed for 'rebuilding Iraqi installations destroyed in the war with Iran'. All these reports were strongly denied on 20 April by Thamir Razzuki al-Shaykhli, the Iraqi Minister of Finance.

However the reports persisted; and rumours circulated among the banking

	Total 1974-1980	1974	1975	1976	1977	1978	1979	First half 1980
United States	55.1	11.5	7.9	11.1	7.5	0.4	7.1	9.6
Eurobanking market	99.0	22.5	8.0	11.0	12.0	2.5	28.5	14.5
United Kingdom	13.3	7.5	0.3	- 1.0	0.8	0.2	2.5	3.0
Other developed countries	55.0	6.5	9.7	9.3	9.2	5.8	2.5	12.0
Less developed countries	48.2	6.0	7.3	7.5	8.5	6.0	8.0	5.0
International organisations, IMF position, SDRs, gold	10.5	3.8	4.2	1.2	0.5	-0.5	-0.5	1.8
Total allocated:	281.0	57.8	37.5	39.0	38.5	14.4	48.0	46.0
Investible cash surplus[1]	318.8	60.3	39.0	39.8	42.3	17.5	59.5	60.5
Discrepancy	37.8	2.5	1.5	0.8	3.8	3.2	11.5	14.5

Table 19: OPEC's investible surplus, 1974-80, in billions of US dollars. Note: [1]Current account surplus less lag in receipts of oil revenues plus net borrowings.

Source: US Treasury Department.

Item	1978	1979	1980[2]	1981	1982
Oil export earnings[1]	130	196	279	296	315
Non-oil exports (f.o.b.)	11	16	18	22	27
Natural gas	(1)	(2)	(3)	(5)	(7)
Imports (f.o.b.)	-106	-107	-133	-173	-211
Trade balance	35	105	164	145	131
Services credits	23	27	37	51	59
Services debits	- 56	- 58	- 69	- 88	-106
Private transfers (net)	- 5	- 6	- 8	- 10	- 11
Current account balance (excluding official transfers)	- 3	67	124	98	73
Official transfers (net)	- 4	- 5	- 7	- 9	- 9
Current account balance	- 7	62	117	89	64
Current account position of OPEC:					
Countries in surplus	13	65	117	102	70
Countries in deficit	- 20	- 3	-	- 13	- 6

Table 20: OPEC's current account position, in billions of dollars. Notes: 1: oil export revenues less foreign oil company profits earned in OPEC countries; 2: estimated average OPEC oil price in 1980 was about $30.97 (including premiums), or 67% above the $18.59 average level in 1979. Average OPEC oil output was 27.7 million barrels per day, of which 25 million were exported; 3: the Treasury's projected 1981 OPEC oil price, used here, is $35.98 per barrel, 16% above the 1980 level (average production and exports: 25.5 and 22.7 million barrels per day respectively); the projected 1982 average oil price used by the Treasury here is $38.69 - 7.5% above the 1981 level (production and exports: 25.7 million and 22.5 million barrels per day respectively.

Source: US Treasury Department.

community in Bahrain that Iraq had actually been seeking loans worth no less than $14 billion from Saudi Arabia, Kuwait, the United Arab Emirates and Qatar. On 21 April, the Kuwait News Agency confirmed that the National Assembly had finally approved a government Bill authorising a $2 billion loan to Iraq, which would be extended in six instalments. Thus $500 million was to be provided by the end of April, and $300 million in each of the subsequent five months. Repayment was to be made over a period of ten years, free of interest, beginning in April 1984. Banking sources in Bahrain have since advised that the Kuwait loan was 'topped-up' with a further $1.5 billion from official funds, that Saudi Arabia's contribution was raised to $5 billion, and that the United Arab Emirates and Qatar augmented the Iraqi bailing-out fund by $1.5 billion between them.

In Table 20, the Treasury projects a sharply reduced aggregate OPEC surplus of $64 billion in 1982, after $89 billion this year. These projections are based, *inter alia*, on an official assumption of an average 1981 OPEC oil price of $35.98 per barrel (including premiums) or 16% above the average 1980 level (in dollar terms). The projected 1982 average OPEC oil price is put at $38.69 per barrel, about 7.5% higher than the average 1981 level, but lower than the Energy Department's oil price assumption mentioned earlier (see Table 2).

Estimates of OPEC's oil surpluses are currently in almost total disarray, as analysts try to assess what is happening to demand for the cartel's petroleum. In January, Morgan Guaranty projected a 1981 OPEC current account surplus of $110 billion. In the following month, First National Bank of Chicago forecast one of $86 billion. It has since reduced its estimate for the 1981 current account surplus to $68 billion (see Table 21). The same respected source has

Country	1980	1981
Saudi Arabia	43.7	46.0
Kuwait	15.4	15.1
United Arab Emirates	7.2	5.0
Iraq	9.1	- 6.6
Iran	- 3.9	- 0.9
Libya	12.0	9.5
Qatar	3.8	4.4
Algeria	0.7	- 0.1
Other OPEC	7.7	- 4.8
Total:	95.7	67.6

Table 21: OPEC's current account balances (estimated data, in billions of dollars).

Source: First National Bank of Chicago.

forecast Saudi Arabia's net foreign assets this year as being likely to rise to $167 billion, compared with an estimated $121 billion at the end of 1980. Investment income accruing to Saudi Arabia is expected to amount to $14 billion. As for Kuwait, First National Bank of Chicago puts Kuwait's net foreign assets at $75 billion, compared with $60 billion last year. Investment income in 1980 is projected at $6.6 billion. These calculations, which take account of Kuwaiti holdings invested through national financial institutions other than the Central Bank of Kuwait, have little in common with data publicised by the International Monetary Fund. ●

* * *

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3 See 'OPEC's secret plan to fleece the world': Report of OPEC's Ministerial Committee on Long-Term Strategy, International Currency Review, Volume 12, Number 3 (July 1980), pages 9-27: Full text of the Ministerial Committee's final draft proposals, minus one page, leaked to International Currency Review by an impeccable source. See also a follow-up report entitled 'Overhauling the cartel's scheme to fleece the world', in International Currency Review, Volume 13, Number 3 (July 1981), pages 34-40.

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11 Cited in 'Iran: the financial aspects of the hostage settlement agreement', a report of the Committee on Banking, Finance and Urban Affairs, House of Representatives, July 1981, page 4.

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13 A theme explained in successive recent issues of International Currency Review, especially in the US dollar sections.

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15 Richard Ehrenberg, Capital and Finance in the Age of the Renaissance: a Study of the Fuggers and Their Connections, Augustus M Kelly, 1963.

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21 This was a familiar Treasury line, and Bergsten frequently stressed it in testimony and other forums.

22 This was one of the main findings of the Banking, Finance and Urban Affairs Committee's report.

23 Letter of 10 January 1978 which appears in the Congressional Record of 23 February 1978 at H 1403-1408.

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25 Letter from Assistant Treasury Secretary Bergsten dated 19 April 1979 to the General Accounting Office.

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27 General Accounting Office report entitled 'Use of Exchange Stabilization Fund Resources: Arrangement with Treasury to provide access to information', 28 September 1977, page ii.

28 See Mark Hulbert, 'The Exchange Stabilization Fund', a case study in the

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31 Stephen D Hayes, a foreign affairs officer with the Treasury Department, 'Joint Economic Commissions as instruments of US foreign policy', reproduced in International Currency Review, Volume 9, Number 5, pages 25-33.

32 C Fred Bergsten, formerly Assistant Secretary of the Treasury for International Affairs, in a keynote speech on US-Saudi Arabian economic interests to the American Arab Association for Commerce and Industry in New York, 18 March 1980. Among Mr Bergsten's more interesting comments on this occasion were references to the fact that over 400 US firms had established offices in Saudi Arabia by March 1980. Mr Bergsten also confirmed that 'over 30,000 Americans are living in Saudi Arabia', and that 'the vast majority of trade is carried on outside the aegis of the Commission' which 'does not by any means encompass all American involvement in Saudi Arabia'. But 'the Joint Commission symbolises the close relationship between the United States and Saudi Arabia, and has emerged in its own right as an important vehicle for bilateral technical cooperation'. Yet the importance of the Commission as a conduit for the channelling of business contracts to the United States only becomes apparent on learning of the scope of some of the projects being developed through the Commission's channels. Of these, the most important is the POWERGRID project which will theoretically involve the expenditure of more than *$70 billion* over a 25-year period on generating, transmission and distribution facilities (assuming an annual inflation rate of some 7%, on average).

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34 'Joint Commission activities', issued by the Joint Commission, US Treasury, 7 April 1978, page 6.

35 'Joint Commission activities', 8 June 1978, US Treasury, page 1.

36 'Joint Commission project activities report', April 1981, page 4.

37 See International Currency Review, Volume 11, Number 6 (January 1980), page 28: Table of OPEC direct investments in the United States.

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44 Remarks of Mr Eugene Sherman, then Vice-President of Merrill Lynch Government Securities Inc, New York, in testimony before the Subcommittee of the US Senate Committee on Foreign Relations, 21 September 1977; cited by International Currency Review, Volume 9, Number 5 (November 1977), pages 54-64.

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46 See note 45.

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96 Letter from Roland H Cook, Secretary, Federal Financing Bank, to Schlickeisen, 26 April 1977.

97 Arab-Asian Affairs Number 101, June 1981, page 3.

98 General Accounting Office report, 'The Defense Department's systems of accounting for the value of foreign military sales need improvement', 16 March 1979, page 1.

99 General Accounting Office report entitled 'Centralization: Best long-range solution to financial management problems of the foreign military sales program', 17 May 1979, page 3.

100 Restricted General Accounting Office document entitled 'Correct balance of Navy's foreign sales trust fund unknown', 15 November 1978.

101 Letter from Allen R Voss, Director, General Government Division, General Accounting Office, to Paul H Taylor, Vice-President and Treasurer, Federal Financing Bank, 28 February 1980.

102 See, for example, statement of Mr Roger W Mehle, Assistant Secretary of the Treasury (Domestic Finance), before the Subcommittee on Economic Stabilization of the House of Representatives' Banking, Finance and Urban Affairs Committee, 7 May 1981, in which he remarked (on page 5 of the transcript) that 'the Federal Financing Bank seems to have become a scapegoat for the Federal credit program control problems which have arisen. It is a common misconception that the Federal Financing Bank, because of its off-budget status, is in itself a means to avoid budget control'.

103 Sharif Ghalib, 'the US gets the oil money back', Euromoney, April 1980, pages 119-124.

104 'The geopolitics of oil', staff report prepared for the Senate Committee on Energy and Natural Resources, December 1980, page 51.

105 Monthly Report of the Deutsche Bundesbank, May 1981, page 28.

106 London Currency Report, Volume 9, Number 14 (22 June 1981), pages 1-4.

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NOTE: On Saturday 19 September 1981 the radical Arab States, meeting in Libya, called for 'closer ties' with the Soviet Union, and urged Arab oil-producing countries to withdraw funds from American banks. This statement was publicised after this testimony had been prepared. The time is clearly considered ripe for international public opinion to be moulded to accept the imminent Sovietisation of Libya, Algeria, Syria and South Yemen and for Moscow's campaign to undermine the petrodollar-based financial system to be given greater impetus. Of course, the mentioned countries have long been in the Soviet orbit (notwithstanding Algeria's 'objective' intermediary status as the go-between during the hostages crisis between Iran and the United States). With Iran on the brink of Sovietisation and Iraq heavily indebted to Moscow, substantial progress has been made by the Soviets in destabilising and radicalising the petroleum cartel.

[Whereupon, at 12:20 p.m., the subcommittee adjourned, to reconvene at 10 a.m., Wednesday, September 23, 1981.]

FEDERAL RESPONSE TO OPEC COUNTRY INVESTMENTS IN THE UNITED STATES

(Part 1—Overview)

WEDNESDAY, SEPTEMBER 23, 1981

HOUSE OF REPRESENTATIVES,
COMMERCE, CONSUMER,
AND MONETARY AFFAIRS SUBCOMMITTEE
OF THE COMMITTEE ON GOVERNMENT OPERATIONS,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2247, Rayburn House Office Building, Hon. Benjamin S. Rosenthal (chairman of the subcommittee) presiding.

Present: Representatives Benjamin S. Rosenthal, Eugene V. Atkinson, Stephen L. Neal, Lyle Williams, and John Hiler.

Also present: Representative Elliott H. Levitas, of Georgia.

Staff present: Peter S. Barash, staff director; Stephen R. McSpadden, counsel; Eleanor M. Vanyo, secretary; and Jack Shaw, minority professional staff, Committee on Government Operations.

Mr. ROSENTHAL. The subcommittee will be in order.

We continue today the hearings on the Federal response to OPEC country investments.

Our first witness is the Honorable Marc E. Leland, Assistant Secretary of Treasury for International Affairs.

We are delighted to have you here.

STATEMENT OF MARC E. LELAND, ASSISTANT SECRETARY OF TREASURY FOR INTERNATIONAL AFFAIRS

Mr. LELAND. I welcome this opportunity to appear before the subcommittee to present the views of the administration on foreign investment in the U.S. and the Federal role in monitoring and analyzing international investments in this country.

As you know, U.S. policy traditionally has welcomed to the United States foreign investment that enters our economy in response to market forces. In our opinion, this open investment climate has served us well. Throughout our history foreign investment has created jobs for U.S. workers, broadened U.S. capital markets, and contributed to U.S. productivity and economic growth.

At the present time, investment in the United States, both foreign and domestic, is critical to the revitalization of our economy. Implementation of the President's economic program, which will place our economy on a stable path of real growth and reduced inflation, should enhance the ability of the United States to compete with other countries for scarce investment-capital and should attract such capital. These macroeconomic policies will supplement the traditional attractions that America offers to foreign investors—the largest market in the world, political stability, a large pool of skilled labor, an extensive and sophisticated infrastructure and distribution system, and a large, accessible capital market.

Our sizable direct investments abroad, which totaled over $213 billion at the end of 1980, are also important to the U.S. economy, and to the strength of the dollar. U.S. investment income on direct investment abroad amounted to about $37 billion in 1980, more than offsetting our merchandise trade deficit of $25.3 billion. U.S. affiliates abroad supply the United States with important imports and provide a sizable market for U.S. exports.

Data from a recently completed Department of Commerce benchmark survey of U.S. direct investment abroad provides a good perspective of the importance of foreign investment. In 1977, roughly a third of our exports, or $40.8 billion, were shipped to foreign affiliates of U.S. corporations, while foreign affiliates of U.S. corporations accounted for $41.5 billion of imports to the United States, or slightly less than one-fourth of total U.S. imports in 1977. Measures taken by other governments to influence or to restrict international investments are, therefore, of particular concern to us. We have been working in various multilateral and bilateral fora to reduce the intervention of foreign governments in private investment decisions.

Just as an open economy is vital to the success of the President's economic program, nondiscriminatory treatment of foreign investments and nonintervention in free market mechanisms are essential if we are to make the most efficient use of available capital. In contrast, investments guided or determined by Government negotiation or restriction will not fully produce the benefits we seek. Rather, such a policy is likely to limit investment in this country and lead to economic activity of a nature that often cannot be sustained without continued Government intervention and support.

For this reason, U.S. policy is based on the principle that nonresidents enjoy the same privileges and responsibilities as resident investors—that is, what we call national treatment. A pragmatic assessment of our national interest today, coupled with our drive for open markets with a minimum degree of Government interference, reinforces our conviction that this policy of nondiscrimination continues to serve our country's interests best.

A REVIEW OF OUR INVESTMENT POLICY

Because investment is important to the U.S. economy, this administration wants to make sure our policies regarding international investment are compatible with our overall economic policies and programs, and thus support the goals of those programs. This administration has decided, therefore, to conduct a comprehensive review of U.S. international investment policy—the first since 1977—under the aegis of the Cabinet Council on Economic Affairs.

A special Working Group on International Investment has been established to consider whether U.S. investment policies are fully appropriate in light of our domestic economic objectives. One of the issues that the working group is looking at rather closely is direct investments in the United States by foreign governments and government-owned entities. We are carefully considering the problems that might arise from such investments, the adequacy of the current mechanisms in responding to those problems, and possible modifications to existing mechanisms, including whether or not the mandate of the Committee on Foreign Investment in the United States [CFIUS] is sufficient. The working group will also consider a large number of other issues, including the adequacy of current U.S. statistics on international investments.

Virtually all the Cabinet-level agencies are represented on the working group. This broad composition will insure that the full spectrum of national interests is brought to bear in consideration of individual investment policy issues. In addition, the group will seek the counsel of U.S. business and independent agencies, in particular the Overseas Private Investment Corporation, the Federal Reserve Board, the Federal Trade Commission, and the Securities and Exchange Commission.

I have outlined the approach this administration is taking toward foreign investment in order to underscore the continuity of our commitment to the fundamental principles that have guided our country's investment policy historically and the equally firm commitment of this administration to take a fresh look at problem areas to insure that the policies we adopt are in our Nation's overall best interests. We look forward to a cooperative relationship with this subcommittee as we address these issues.

With these elements as background, I would like to turn to the matters which this subcommittee has raised concerning Federal efforts to monitor, analyze, and report on foreign portfolio investment in the United States, with special focus on the adequacy of our information base. I am providing answers to the subcommittee's specific questions, contained in your letter to me of July 15, as an annex to this statement.

IMPROVEMENTS TO THE INTERNATIONAL PAYMENTS DATA

The Foreign Investment Study Act of 1974 and its successor, the International Investment Survey Act of 1976, expanded the executive's authority to collect data from U.S. persons for purposes of analyzing international investment affecting the United States—both outward investment and inward investment. Since the passage of the 1974 act, our coverage of international investment activity has been expanded and improved.

Several comprehensive surveys have been undertaken to benchmark the magnitude, source, and direction of foreign investment involving the United States. A study of the feasibility of benchmarking U.S. portfolio investment abroad has been completed. At the same time, the Treasury's International Capital Reporting System [TIC system] has been revised in such a way as to provide a clearer idea of the forms portfolio investment takes. New efforts are continually under way to improve our data collection systems, the most significant recent instance of which has been the initiation of an investigation into the statistical discrepancy in our balance of payments and consideration of possible means of reducing it—covered in greater detail in the annex to my statement.

THE 1978 BENCHMARK SURVEY OF FOREIGN PORTFOLIO INVESTMENT IN THE UNITED STATES

Since this subcommittee last held hearings on foreign investment in the United States, the Treasury has completed its second comprehensive survey of portfolio investment in this country. Such 5-year surveys not only benchmark the data we collect monthly, but supplement these regular data by providing detail on the sectors of our economy into which portfolio investment is flowing. The information derived from the 1978 survey will be of interest to the subcommittee, and I would like to summarize it. The data I will cite and our analysis of it will in all cases cover only what was reportable under the survey, that is, long-term marketable securities which did not represent direct investment—that is 10 percent or more of the outstanding stock of a given corporation.

One of the most significant benefits drawn from the latest benchmark survey was confirmation of the basic content and reliability of Treasury's regular system for collecting information on foreign investors' transactions in U.S. securities. The survey indicates in particular that the TIC system is highly reliable, capturing virtually all of the flows that are reportable under the system for foreign investments in U.S. equity securities. The regular reporting systems show that $154 billion of new net foreign portfolio investments entered the United States between 1974 and 1978. The latest benchmark survey showed that the value of such investment over this period rose by $159 billion. The difference is largely attributable to changes in security prices, especially for equities which rose sharply from the market lows of 1974. Adjusting for estimated valuation changes and differences in coverage, the TIC system has picked up all but $133 million of new foreign equity holdings. On the other hand, the TIC system measured $1.1 billion more in net foreign purchases of U.S. debt securities than was indicated by the increase in foreign holdings of these instruments between benchmark years. I might note that almost all of the $1.1 billion difference applies to foreign holdings of long-term U.S. Treasury securities. This difference is probably due to underestimation of security value changes, errors in measurement, or both. The magnitude of the discrepancy—less than 1 percent—is so small, however, that it does not represent a matter of significant concern.

The results of the survey are also extremely useful in putting in proper perspective the scope of foreign portfolio investment in the United States The survey shows that such investments: were not concentrated in the hands of a few countries; were small in comparison to the size of our market; and did not dominate one or more of our economic sectors.

The facts are as follows:

One, nonresident ownership of marketable long-term U.S. securities was widely dispersed among foreign holders. No single country accounted for more than 15 percent of total foreign portfolio investment. Moreover, the bulk of these investments was held by residents of other developed countries. Nearly 70 percent was held by investors resident in Europe, Canada and Japan.

Two, foreign portfolio investors held only 4 percent of total long-term marketable securities—debt and equity—issued by U.S. firms; that is only $54.5 billion of a total of nearly $1.4 trillion.

Three, most of these holdings were in issues of the largest U.S. corporations—almost 80 percent of them in securities of corporations with total assets of $1 billion or more.

Four, the oil-exporting countries accounted for about 20 percent of foreign holdings of marketable long-term U.S. securities.

Five, in terms of voting power, foreign portfolio holdings of equity securities exceeded 10 percent of the total of such securities outstanding in only one of the 64 economic sectors covered in the survey. In nonmetallic minerals other than fuels, the share was 12.85 percent. Foreign investors held 2.6 percent of the voting shares of corporations in the agricultural crop sector; 5 percent in oil and gas extraction; 5.7 percent in chemicals and allied products; 6.7 percent in electrical and electronic components; and 3.5 percent in banking.

As the subcommittee is aware, the data reported to the Treasury under the TIC system and the benchmark surveys are based on the holder of record. Although the last benchmark survey required domestic nominees to disclose the country of residence of the owner of portfolio assets held in trust, the survey data do not necessarily indicate the ultimate beneficial owner. We know of no practical means of obtaining this type of information on a comprehensive and consistent basis.

OPEC

The subcommittee has expressed interest in our collection and analysis of data pertaining to OPEC investments. At this juncture in your view of foreign investment activity, we understand your concern to be primarily focused on OPEC portfolio investments in stocks—where control or influence is not sought—bonds, and Government securities.

Since the price of crude oil quadrupled in 1974 and OPEC countries began to accumulate large payments surpluses, the disposition of those surpluses has been a matter of interest. As this subcommittee knows, OPEC countries are extremely sensitive about the possible disclosure of their individual investments abroad. This concern was reiterated to Secretary Regan during his recent trip to the Middle East. Such disclosure would constitute unnecessary and counterproductive interference in the affairs of foreign investors. The present statutory and policy stance of maintaining confidentiality of the affairs of individual investors—public or private—is in our view a proper one, subject, of course, to compliance with U.S. law such as that governing reporting of large acquisitions of voting securities.

Investments in the United States by the major oil-producing countries of the Middle East and Africa continue to be almost exclusively investments by official institutions. From time to time there have been expressions of public concern that investments by foreign governments, including OPEC governments, could be politically motivated and take a form that might be harmful to U.S. interests. The Government responded to these concerns in 1975 by establishing a special procedure which called for advance notification to the U.S. Government of any major investment in the United States by a foreign government—excluding investments in U.S. Government securities, bank deposits, et cetera—and for review by a special interagency committee of any foreign governmental investments here which might have adverse implications for the national interest. These procedures have been and continue to be applicable to investment by any foreign government. As I noted earlier, the adequacy of this mechanism will be reviewed thoroughly by the new Working Group on Foreign Investment.

As to the figures, since January 1, 1974, roughly $59½ billion—approximately 18 percent of identified OPEC placements worldwide—has been invested in the United States. Based on the data from the benchmark survey, which are carried forward with annual investments from the TIC series, we estimate that the total of holdings by oil-exporting countries in the United States at the end of last year was $61.9 billion. About 83 percent comes from Middle East oil-exporting countries.

OPEC holdings continue to be concentrated in U.S. Government securities. In 1980, for example, OPEC purchases of Treasury bonds and notes of over $8 billion far exceeded the total net purchases of $3.3 billion by all foreigners, indicating a decline in the holdings of all other foreign investors. We estimate that OPEC holdings had increased to 22 percent of all foreign holdings of U.S. Treasury bonds and notes as of the end of 1980.

Although OPEC investments represent sizable holdings, they are generally a small percentage of total foreign investment in the United States, and a tiny share of combined total foreign and domestic investment in such assets.

Oil-exporting countries account for 19 percent of all foreign holdings of all Treasury securities, but under 3 percent of total Treasury debt outstanding.

The OPEC portion remains small in comparison to our domestic market for portfolio securities.

Direct investment holdings by OPEC continue to account for only 1 percent of total foreign direct investment in the United States.

CONCLUSIONS

Therefore, in conclusion, this administration welcomes foreign investment. It represents not a threat, but an opportunity for the United States to strengthen our economic structure and revitalize our economy. But investment decisions in the United States and abroad must be made in the context of free and open markets. Only in this way can international capital markets allocate resources effectively and efficiently.

It goes without saying that we continue to expect foreign investment in the United States to conform fully with existing U.S. laws and regulations and all foreign investors to continue to act responsibly in conducting their business affairs in this country.

These hearings come at an opportune moment as we begin the review of our foreign investment policies and programs. I can assure the subcommittee that its views and concerns will be fully factored into our assessment. Our goal is to insure that our overall national interest is protected and that our investment policies are both fair and effective. I am sure this subcommittee shares this goal.

Thank you very much.

Mr. ROSENTHAL. Thank you very much, Mr. Secretary, for a very useful statement.

The first two paragraphs of the conclusion, was that in any other previous statements that you know of? Was that copied from last year's statement, or statements from 4 years ago or 8 years ago?

Mr. LELAND. The last two paragraphs?

Mr. ROSENTHAL. The first two paragraphs of the conclusion, "This administration welcomes foreign investment."

Mr. LELAND. It could have been.

Mr. ROSENTHAL. It would have been.

Mr. LELAND. Not that I know of.

Mr. ROSENTHAL. I sense I have seen it before.

Mr. LELAND. It is certainly a statement of our policy.

Mr. ROSENTHAL. Not being facetious, but those two paragraphs could have been used in the statement that President Monroe might have sent up, his assistant secretary could have read, the same statements, right?

Mr. LELAND. It reads more modern than that.

Mr. ROSENTHAL. The language may be different, but in terms of substance it would have been essentially the same thing.

Mr. LELAND. I would imagine so.

Mr. ROSENTHAL. Does that take into account the realities of the vast resources of OPEC countries, and their need to place that money somewhere in this world?

Mr. LELAND. Taking the entire statement in context, and taking what we are trying to do in reviewing it, it does.

Mr. ROSENTHAL. Maybe the testimony that we can develop will illustrate somewhat more forcefully the point I am trying to convey. The conclusions about the desirability of foreign investment may be very different than those which existed 200 years ago, 100 years ago.

You are aware of what has happened since 1973?

Mr. LELAND. Yes, sir.

Mr. ROSENTHAL. Is that fed into these two paragraphs in the conclusion?

Mr. LELAND. Yes. It goes without saying we continue to expect foreign investment in the United States to conform fully with existing U.S. laws and regulations.

Mr. ROSENTHAL. Every President since Washington has said that.

Mr. LELAND. The laws have continually changed.

Mr. ROSENTHAL. If I read these conclusions cold—I am going to say I am not sure where I read this, it was either the one Harding or Coolidge or Monroe sent up.

Mr. LELAND. You read them all?

Mr. ROSENTHAL. There seems to be a discrepancy as to what the total OPEC investment in the United States is.

The Commerce Department says there is $50 billion missing, is that correct?

Mr. LELAND. I don't know of what you are speaking.

There is a problem in the Department of Commerce balance of payment figures for 1979 and 1980.

There are other figures we often hear—estimates of what OPEC foreign investment is, foreign surpluses are—and how much we can account for; there are discrepancies between those figures, all of which are not necessarily available to us.

Mr. ROSENTHAL. Does the U.S. Government or any agency have an accurate assessment of what total foreign investment is in the United States?

Mr. LELAND. I think that we have a relatively accurate assessment of what total foreign investment is in the United States, yes.

Mr. ROSENTHAL. Including real estate holdings, corporate, Netherlands Antilles, third party holdings, corporate holdings, disguised holdings, undisguised, foreign government investors, private investors?

Mr. LELAND. To be perfectly accurate, I don't think we do.

Mr. ROSENTHAL. How far might we be from accuracy?

Mr. LELAND. That is one of the things we are looking at.

Let us take the area where the specific interest is—an area which is much more in the Commerce Department area but also in mine because we are dealing with it in our review group. In the area of direct investment, where someone owns more than 10 percent of any company that is doing business here, I think we are very accurate.

The SEC disclosure requirements are very good.

Mr. ROSENTHAL. You say the SEC requirements are good. The Securities Industry Association submitted a statement to this subcommittee yesterday which I believe criticized the Treasury's ongoing data collection system and they furnished a copy of the statement to you a week ago.

Mr. LELAND. I did read it.

Mr. ROSENTHAL. They said major problem, one; noncompliance by U.S. firms although unintentional; two, poor reporting by other firms; and three, the difficulty in calculating the amount of total foreign ownership within a firm. And those people recommended Treasury take corrective action, including steps to publicize and enforce reporting requirements, as well as a thorough evaluation of Treasury guidelines.

In the face of that, is your system reliable?

Mr. LELAND. I don't think it is perfectly reliable. There is a lot of room for improvement. Exactly what you stated there is correct.

Mr. ROSENTHAL. Acknowledging there is room for improvement, what we are trying to do is to get an assessment of the gap between what you believe to be and what the Federal Government reports to be the foreign investment in the United States, and in reality what is in fact the foreign investment in the United States.

Mr. LELAND. Yes.

Mr. ROSENTHAL. Should we in any other way in any area be concerned about foreign investment in the United States?

Mr. LELAND. Yes.

Mr. ROSENTHAL. In what ways?

Mr. LELAND. First of all, I think one wants to know within a general reasonable area of discrepancy what the investment is and where it is.

Two, I think we are concerned, particularly on direct investment, as to what that direct investment is.

Three, I personally believe, and this is one of the things that our committee is taking a close look at, that Government ownership of direct investment——

Mr. ROSENTHAL. Why is that important?

Mr. LELAND. One of the reasons it is important is one has to analyze whether or not these entities would operate in a profit maximizing way.

You can say that the free and open system is fine, so long as it operates that way.

Obviously you can get yourself into a situation where a purchaser might make a purchase that was not for profit maximizing.

Mr. ROSENTHAL. What kind of purchase would that be, if not for profit maximizing?

Mr. LELAND. There might be national interests that overcame—

Mr. ROSENTHAL. National political interests?

Mr. LELAND. Yes.

Mr. ROSENTHAL. That is the reason we are interested in having this information.

Now, following that through, and you have stated it quite accurately, is it important to know this data country by country?

Mr. LELAND. To some degree, certainly as to direct investment it is important to know it country by country.

Mr. ROSENTHAL. You mean what?

Mr. LELAND. Ownership of companies. I don't think it is important to know exactly country by country what their ownership is with respect to the over $1 trillion worth of U.S. Government securities which are outstanding. It is not essential that it be known country by country.

If a country owns General Motors or Boeing, it is important.

Mr. ROSENTHAL. Is it, or is there a distinction between the motivations of individual or corporate investors as compared to government investors. In other words, government investors may have a political concern that an individual investor might not have. Is that a reasonable statement?

Mr. LELAND. Yes.

Mr. ROSENTHAL. In terms of the future, 10 years from today, what do you think the totality, or what have you projected the totality of Mideast OPEC country government investments in the United States to be?

Mr. LELAND. I don't know of any such projection that we have done. We know basically what their purchases have been at the Treasury and what foreign investment has been. Basically their investments have been in U.S. Government securities, and then to a lesser extent in private corporate securities of large corporations—and of a small enough percentage that it has not made a large difference.

Mr. ROSENTHAL. We had a figure thrown at us yesterday, in 10 years, Saudi Arabian surpluses available for investment would be $1,600 billion.

Mr. LELAND. I saw that.

Mr. ROSENTHAL. How does that shake you?

Mr. LELAND. I don't see anything in any of the figures I have that indicates there is any accuracy to that.

I was in Saudi Arabia in May, and saw that they have enormous development projects of their own to use these funds in their own country—so I don't know where that figure comes from.

Mr. ROSENTHAL. Take Saudi Arabia for the sake of discussion. What is their surplus available for foreign investment in 1980 or 1979?

Mr. LELAND. Offhand I don't know the exact figure.

Mr. ROSENTHAL. You must have some information.

Mr. LELAND. It is in the annex to my testimony.

The OPEC one was more like $120 billion, before including official transfers.

Mr. ROSENTHAL. The total?

Mr. LELAND. $110 to $120 billion as their surplus.

Mr. ROSENTHAL. I refer to your statement. The Treasury figure for 1980 is $107 billion. That is for current account balances, $107 billion?

Mr. LELAND. Right. That is the figure after including official transfers.

Mr. ROSENTHAL. Now, what do you project it to be for 1981?

Mr. LELAND. I don't have a projection.

Mr. ROSENTHAL. 1982?

Mr. LELAND. A lot depends upon oil prices.

If you go back historically, we were told from 1974 to 1978 that indicates there was absolutely no way the world would absorb these price increases, and yet it did.

Mr. ROSENTHAL. Are you predicting that oil prices are going to come down?

Mr. LELAND. I won't make a prediction on that at all.

Mr. ROSENTHAL. But most of us believe, having seen—you go to gas stations to purchase gas?

Mr. LELAND. Sure do.

Mr. ROSENTHAL. And you stand there and watch that meter go round and round and round, and that meter is running, and there is a big meter somewhere in Riyadh that is running faster and faster.

Mr. LELAND. It is running a little slower than it was before.

Mr. ROSENTHAL. About a half billion dollars a day slower, and what we are trying to understand is the figure which the Treasury projects for Saudi Arabia, and albeit, OPEC surplus funds available for investment in the United States in 1985. There must be somebody somewhere making these projections?

Mr. LELAND. You can make projections, but the difficulties with the projections are, Mr. Chairman, one, that the price of oil is fluctuating.

If it goes up at the rate it did in 1978——

Mr. ROSENTHAL. Are you prepared to tell us the price of oil will come down significantly so that the balances will reduce significantly?

Mr. LELAND. No.

Mr. ROSENTHAL. You must have a view on the subject. Oil prices are going to be about the same.

Mr. LELAND. I don't have a view on the subject.

Mr. ROSENTHAL. You are the only one in this room, at least in the front part of the room who just came back from Saudi Arabia.

Mr. LELAND. A few months ago.

Mr. ROSENTHAL. You must have some view of where oil prices are going?

Mr. LELAND. I don't. We can basically say that it looks like they have stabilized but I don't have a general idea of what uses the particular OPEC countries have to put their own funds to. They have got their own development programs.

Mr. ROSENTHAL. Is it your testimony that Saudi Arabia will not have a surplus in 1981?

Mr. LELAND. I think it will have a surplus, and also in 1982.

Mr. ROSENTHAL. I am trying to get an impression from you of where we will be in 1985.

Mr. LELAND. They will have a surplus. I remember looking at the figures when I first started this job in March. The surpluses were estimated to be considerably larger because people were talking about $45 a barrel for oil, instead of $32 a barrel.

Meanwhile, the OPEC nations, so far as I can tell—I hesitate to hazard a guess—but so far as I can tell, they were making their expenditures based upon that increase, and if they don't have the increase but they still keep up with their expenditure plan, that reduces their surplus.

Mr. ROSENTHAL. I appreciate the generalized tone of your comments, but I still cannot believe that you don't anticipate or have any prognosis of where the available funds will be.

Mr. LELAND. I do not.

Mr. ROSENTHAL. Let's get down to specifics.

In the Treasury Department, is there a Saudi Arabian procurement staff under your administration?

Mr. LELAND. As part of the Joint Economic Commission, yes.

Mr. ROSENTHAL. How many people are there?

Mr. LELAND. In the Joint Commission itself there are a few hundred. In the procurement staff we are more like about 40 or so. The Office of Saudi Arabian Affairs has 24.

Mr. ROSENTHAL. How about under the Assistant Secretary of Treasury for Administration? How many people do they have there?

Mr. LELAND. About eight.

Mr. ROSENTHAL. Who are they paid by?

Mr. LELAND. Paid by the U.S. Government, and then we are reimbursed by the Saudi Arabian Government.

Mr. ROSENTHAL. They are being paid by the Saudi Arabian Government?

Mr. LELAND. In a reimbursible form. Paid by the U.S. Government and we get reimbursed by them.

Mr. ROSENTHAL. It means they are being paid by a foreign government, albeit indirectly?

Mr. LELAND. Of course, that is right, if you want to put it that way.

Mr. ROSENTHAL. Well, of course, it is right. Why do you say if I want to put it that way? Do any other governments have that group of people in the Department of the Treasury?

Mr. LELAND. So far as I know, no one has offered us that.

Mr. ROSENTHAL. In totality, how many Saudi Arabian reimbursables do you have in the Treasury Department?

Mr. LELAND. A certain number overseas working in Riyadh, and certain numbers working here. We have a couple of hundred overseas.

Mr. ROSENTHAL. Treasury Department employees paid by Saudi Arabia?

Mr. LELAND. Under the Joint Commission.

Mr. ROSENTHAL. Are these American nationals or Saudis?

Mr. LELAND. American Nationals.

Mr. ROSENTHAL. What do they do in your Department?

Mr. LELAND. They provide backup for projects that are being performed in Saudi Arabia.

Mr. ROSENTHAL. Do they know who is paying their salary?

Mr. LELAND. Sure.

Mr. ROSENTHAL. Do you think there is any apparent, almost shocking conflict of interest in that?

Mr. LELAND. I don't think so; no, I don't.

Mr. ROSENTHAL. Well, suppose the Soviets offered you that kind of a deal. Do you think there would be a hue and cry in this country?

Mr. LELAND. I can't see the Soviets offering that kind of deal.

Mr. ROSENTHAL. To whom do these people owe their loyalty?

Mr. LELAND. The Soviets are also a different story.

Mr. ROSENTHAL. To whom do these people owe their loyalty?

Mr. LELAND. They are U.S. nationals, and they owe their loyalty to the Joint Commission.

Mr. ROSENTHAL. Their salary is being paid indirectly by a foreign government?

Mr. LELAND. Exactly.

Mr. ROSENTHAL. To whom do these people owe their loyalty? Think about it. You are a lawyer with great experience.

Mr. LELAND. The issue does not arise. They are U.S. citizens and, therefore, owe their loyalty to the U.S. Government.

I would say the same question would arise—Are you saying if any U.S. person goes to work in any country and gets paid by that country, he is, therefore, not loyal to the United States but loyal to that country?

Mr. ROSENTHAL. Do these people work in your building?

Mr. LELAND. Some do and some don't.

Mr. ROSENTHAL. In your building you have American nationals being paid by a foreign government.

Mr. LELAND. No. They are being paid by the U.S. Government and the United States is being reimbursed.

Mr. ROSENTHAL. With money handed over by another government?

Mr. LELAND. Yes.

Mr. ROSENTHAL. I just raise the question of whose interest are they working on behalf of?

Mr. LELAND. In my view, in behalf of the U.S. Government.

Mr. ROSENTHAL. Why don't we pay them directly?

Mr. LELAND. We hire them.

Mr. ROSENTHAL. Why not pay them directly?

Mr. LELAND. Because the Saudi Arabians have offered a reimbursable deal and the benefit is to us.

Mr. ROSENTHAL. We could get that deal from any government in the world, to put people under the Department of Defense or Treasury?

Mr. LELAND. Not that would bring us $1 billion worth of business; no, I don't think so.

Mr. ROSENTHAL. I think the Soviets would go for that.

Mr. LELAND. We are not offering it to the Soviets.

We also have export controls on what we export to the Soviet Union.

Mr. ROSENTHAL. On October 13 or 14 we may have controls on what we export to Saudi Arabia.

Mr. LELAND. We have that on strategic and military goods shipped to everybody in the world, to any ally, but other than that, we don't have any special——

Mr. ROSENTHAL. The point of all of this—my colleagues are anxious to pursue this—is the Treasury motivated to report to the American people the totality of OPEC nation investment and influence in the United States, country by country, or by grouping? It does not seem to me there is much motivation to do that.

Mr. LELAND. I don't understand the question.

Mr. ROSENTHAL. In my view, you have a potential fifth column in the Department of the Treasury, and you have reasons for not reporting the totality of Saudi investment in the United States.

I am going to ask you a question, and you are going to refuse to answer. What is the totality of Saudi Arabian investment in the United States?

Mr. LELAND. Because it indicates the amount of one depositor, which is the Saudi Arabian Government, and they would prefer we don't give it. And we won't give it. We do give it as part of a group.

Mr. ROSENTHAL. Because they would prefer, you don't give it to us, you are not going to give it to a validly constituted congressional committee?

Mr. LELAND. That has been the policy, yes.

Mr. ROSENTHAL. Almost every witness prefers not to give information.

Mr. LELAND. This has to do with the confidentiality of banking practices. For instance, if the Saudi Arabians make direct investments in this country for which disclosure would be required by anybody else, you should have it. I have no question about that.

The issue here is the confidentiality of banking transactions that come to us through confidential methods whereby we have said we will respect it, not to release or indicate——

Mr. ROSENTHAL. Government investment is a banking transaction?

Mr. LELAND. Yes, it is. Their investments are made as banking transactions.

Mr. ROSENTHAL. It is shrouded under the cloak of secrecy as a banking transaction.

All banking transactions ought to be denied to the Congress? We ought not have oversight of the IRS or the Treasury Department, we might as well closeup shop.

Do you know the totality of German investment in the United States, direct investment?

Mr. LELAND. Yes.

Mr. ROSENTHAL. Do you know the totality of government investment by the United Kingdom?

Mr. LELAND. Yes.

Mr. ROSENTHAL. Do you know the totality of government investment by the Republic of France?

Mr. LELAND. Yes.

Mr. ROSENTHAL. Do you know the totality of government investment by the Italian Government?

Mr. LELAND. Yes.

Mr. ROSENTHAL. Do you know the totality of government investment by Saudi Arabia?

Mr. LELAND. Yes.

Mr. ROSENTHAL. Would you tell us about the United Kingdom?

Mr. LELAND. Regarding some of the figures, there are governments that have not objected to publication; they don't mind. And too, in some cases, the country figure, Mr. Chairman, does not indicate any individual—it does not indicate the government's holding because the country figure would include all British nationals as well as the government, so it does not indicate any individual depositor.

Mr. ROSENTHAL. You are not satisfied with the extent of Government collection of foreign investment data as of the moment, are you?

Mr. LELAND. No.

Mr. ROSENTHAL. How serious is your dissatisfaction?

Mr. LELAND. I am looking into it now. I have to see how big the discrepancy is, and whether or not it is in areas that really should be of concern.

Mr. ROSENTHAL. How are you going to find what the discrepancy is?

Mr. LELAND. We are trying to go over these figures and determine where the areas that we don't know are.

Mr. ROSENTHAL. The previous administration was looking for this discrepancy, too, and they started 2 years ago. Do you have the benefit of some of their discrepancy "hunters"?

Mr. LELAND. Yes.

Mr. ROSENTHAL. When could we expect an up-to-date report from you as to an assessment of your efforts?

Mr. LELAND. Well, it has been an ongoing process. I would hope in the next few months. We are trying to get more information on it. Commerce has a certain part of it, because they collect a certain amount of the data, and we do, and we are trying to identify it.

Mr. ROSENTHAL. Mr. Hiler.

Mr. HILER. Thank you, Mr. Chairman.

I think you had in your testimony—it may not have been Saudi or OPEC or Mideast countries—investment in U.S. Treasury bills at 4 or 5 percent. Was that something I read in your testimony?

Mr. LELAND. Let me see. We said that as of the end of 1978 OPEC accounted for 20 percent of foreign holdings of marketable long-term U.S. securities.

The last few years their purchases actually have been much larger. In 1980, OPEC purchases of Treasury bonds and notes exceeded $8 billion. I don't think I gave that exact percentage, but I think I have it. I can get it.

Mr. HILER. Do you have that figure offhand?

Mr. LELAND. If it is $8 billion, I should be able to figure it out, out of the total. If I know the total amount of purchases, one should be able to figure it out.

OK. We have the figure for OPEC holdings of Treasury bills and certificates. They held 14 percent, but I am trying to figure the other proportion in the year 1980. We know that the OPEC purchase of Treasury bonds and notes was $8 billion, so if we knew what the total amount of Treasury sales was, we would know the percentage.

Mr. HILER. OPEC today holds 14 percent of the Treasury bills and certificates?

Mr. LELAND. Fourteen percent of bills and certificates at the end of 1980.

Mr. HILER. Whether it is 14 percent or 10 percent or 19 percent, it is in those kinds of percentages. Getting down to my question, if that investment were not being made, what impact do you think that would have on interest rates today?

Mr. LELAND. The percentage is 2.5 percent of the domestic market, and it is 14 percent of foreign holdings.

Sorry. Go ahead. I missed the question, because I wanted to clarify that it was not 14 percent of the domestic market.

Mr. HILER. If that level of investment were not being made, what impact would that have on the interest rate in the country today?

Mr. LELAND. Assuming you had the same supply of securities, and less demand, the interest rates would be higher.

Mr. HILER. Do you think it would be substantially higher, marginally higher?

Mr. LELAND. They are taking a good share of each new offering, 10 and 15 percent of each new offering, so you could argue that it would be somewhat higher.

Mr. HILER. The U.S. Government has somewhat of a vested interest in OPEC or foreign countries continuing to purchase our securities?

Mr. LELAND. Definitely, because we are paying this money for oil, and if we don't get it back directly as an investment, we don't manage to benefit from it.

Mr. HILER. Do you think that the tradeoff for confidentiality is a good tradeoff from that standpoint?

Mr. LELAND. Yes.

Mr. HILER. All things being equal, let's say interest rates were 3 to 5 percent today, and we did not have large amounts of debt, and so we don't need the capital flowing in. Would you continue to say you think secrecy is a good policy?

Mr. LELAND. Yes. It obviously has added to capital inflows. In this particular case, you have banking transactions reported to you in this confidential fashion. I don't see that it does any particular harm. I would see a harm in the secrecy in direct investments, that are required to be disclosed.

Mr. HILER. What harm do you think there is in not having confidentiality?

Mr. LELAND. If you gave that up, I think we might thereby lose some of the investments.

Mr. HILER. Where do you think those investments are going to go?

Mr. LELAND. Abroad, or you might have a situation whereby—well, they would go abroad.

Mr. HILER. Which other country or which groupings of countries would be able to handle the volume of investment that the OPEC nations make in this country?

Mr. LELAND. I don't think anyone really could.

Mr. HILER. In the final analysis, it would still end up coming over here?

Mr. LELAND. A lot of it would, yes.

Mr. HILER. We should probably make the assumption that the OPEC countries are rational investors?

Mr. LELAND. Yes.

Mr. HILER. Would you say that that has been the case?

Mr. LELAND. Yes, that has been the case from every indication.

Mr. HILER. A rational investment policy is always going to have that money coming over here probably?

Mr. LELAND. I think so. Given the size and nature of our market, that would be true. There are, however, other large markets.

Mr. HILER. In the long term, from a strictly financial standpoint, ignoring any political side effects, secrecy or nonsecrecy probably is not going to have an impact on OPEC foreign investment in this country?

Mr. LELAND. On the long term, I wouldn't hazard a guess. Whether they would decide they wanted to buy Eurodollars, and what impact that would have, I couldn't hazard a guess. I basically agree with what you are saying.

Mr. HILER. Thank you very much.

Mr. ROSENTHAL. Mr. Atkinson.

Mr. ATKINSON. Thank you.

You said earlier that other countries don't mind the disclosure, and confidentiality has no meaning to them at all, but in the case of the OPEC nations, it does. Is it a fact maybe the royal families who really are the Government over there—what kind of influence does that have?

Mr. LELAND. I think there are several reasons.

In most countries' cases, the investments do not reveal any individual depositor because you have an aggregate for the United Kingdom, for instance, those investments are made by the Bank of England and a lot of individual investors, so the number does not reveal any specific investor. That is part of it.

In the case of Saudi Arabia, it is known that investment is largely made by one purchaser, the Saudi Arabian monetary authority, so that disclosure of the country aggregate would reveal their figure. They are concerned about that being revealed.

I think you also would have to say, and I think you are right on this point, that different societies have different attitudes toward secrecy, and that attitudes in that society are different than ours.

Mr. ATKINSON. One of the overriding facts is, we are an industrial country depending upon a foreign product, oil, for our national interests, not only for the domestic needs of the country, and their threats are to stop producing it if confidentiality is broken.

Mr. LELAND. All I have heard is that they requested, that they would prefer it be kept confidential.

Mr. ATKINSON. In the Communist countries, they don't mind a disclosure. It would seem to me as though there is nothing they can threaten us with, no other country can threaten us except the OPEC countries, and that is why they are given special tax considerations, special confidentiality.

Isn't it really a political threat? Oil is in our national interest, and the attitude that they assume, and I am assuming their attitude, that they would cut off oil. If that is the case, isn't it more of an economic threat?

Mr. LELAND. It isn't as if there were a figure that the Government isn't getting, because we have it. So far as we know, there is a certain degree of accuracy in it.

Second, my understanding of it is that this information is something that traditionally we have never revealed. Any information on any depositor—and a government is just like any individual depositor—is confidential.

In this case, which you don't ordinarily have, because the nature of the Saudi Arabian Government and the royal family, whatever you want to say—the investments are basically made only by the country, by one depositor. So that gives them the justification to ask for confidentiality. Actually by revealing those investments, we would be changing our normal rule rather than going the other way and, therefore, we continue with it.

Insofar as possible we have broken the oil exporter figure down for its usefulness, including Saudi Arabian investment along with that for other countries. That does not reveal the holdings of one depositor, but it does give the committee the general idea of the dimension of the problem.

Mr. ATKINSON. You suggest the cut in the oil production. Even though it would not be good for the oil market, still there is the feel or the suggestion that this is what they would actually do; that they would actually stop production, or cut back on oil, make their investments somewhere else.

I would like to really know that, if that is a threat that they put on us for the reason we are raising the questions here today and have been for some time now, and that is a case in your international affairs, is there a counterpunch-type situation that we have with them? Is there something they are in need of that we have that we could take the same attitude?

Mr. LELAND. I think what Congressman Hiler said is correct: It is very much a two-way street. Anybody that would say—this is my own belief—that we are totally subjugated to them and have no influence, is wrong.

We have this big, open, free market. This is a place where they can invest with a certain amount of confidentiality. There are a lot of reasons why they will always want to come into the U.S. market. Where else do they have to go?

Mr. ATKINSON. That is the real strong point. The 1979 oil embargo, they didn't take away their investments and withdraw them, is the information I have. Otherwise, I guess we would have to assume, then, that the nondisclosure is just a favor to that country at their request, and if some other country made a similar request, the Eastern bloc, or any country, if they made a similar request, would it be granted?

Mr. LELAND. If it had the justification that this one had, it would be. I think if a country had a situation whereby we released country data which indicates a lot of depositors and not any individual depositors, we would say, "Sorry, this is the way we give our information; always have."

If they had the same circumstances, I would think we would grant it to them because there would be no particular harm, and this is the kind of secrecy we have always followed.

Mr. ATKINSON. I can always understand extending courtesies unless there is a direct threat connected with it, and that is the immediate problem. If that is not the case, then I don't see why we would even be raising the questions, frankly. If there is no threat of what they are going to do by releasing the information to us, I don't see the harm of it, frankly, since every other country is coming forward.

Mr. LELAND. My feeling is that there is a justifiable reason based upon our historical method of how we release investment information. The committee is well aware that there are plenty of other things that they might ask this country to do that this country does not do. So the threat is not an unlimited one.

The basis for confidentiality is, as previous administrations have held—and so far as I can see it is still true—that the way we released figures is an ongoing policy. If it is something they prefer us to keep confidential, we continue to keep it confidential. At the same time we can try to meet the committee's needs in a broader sense, and we ought to do it.

Mr. ROSENTHAL. Incidentally, did you speak with Mr. Parsky about your appearance before this subcommittee?

Mr. LELAND. No, Jerry is always on an airplane.

Mr. ROSENTHAL. Where is he usually going?

Mr. LELAND. California, Washington, God knows. He commutes between here and there.

Mr. ROSENTHAL. He had this job that you now have during a previous administration and now represents Saudi Arabia?

Mr. LELAND. I don't know that he represents Saudi Arabia. He does not work in Saudi Arabia, certainly.

Mr. ROSENTHAL. Mr. Williams.

Mr. WILLIAMS. The thrust of what the committee is interested in is obviously the concern over the secrecy, and I agree with that. I am somewhat concerned about our ability to know, but I am more concerned about what I think is the important need, and I want to know if you think it is important, to make our society aware of potential future investment from any bloc of nations, in this case OPEC.

Do you think it is important that not only this committee know, but our society begin to know of an apparent danger that we think exists, or do you think that danger exists?

Mr. LELAND. In light of what the nature of the investments has been, my answer would be no. I think the Government has to be concerned, and I agree with this, and that is why CFIUS was created, and we are looking at it; that is, owning business in the United States.

I don't feel that the nature and the amount of the purchases compared to the size of our market says that somebody has to go out and say there is this great danger, because the market can adjust to it.

Mr. WILLIAMS. I have difficulty separating what the Government is doing and what is going on in my community, for example, in Youngstown, Ohio. I am very aware of what is happening with Mideast investments in the small business community. They are not going to buy General Motors, but rather the 7-Eleven's, and the rest of the stores, as they are doing, and I have seen a tremendous turnaround in ownership in a hard-hit community like this because of the economic situation, and I see a potential danger in local politics that could exist, if their dedication is not to the U.S. Government. I am not sure it is. I will be frank about it. That bothers me.

Do you think that they are going to try to purchase General Motors or not buy the small business here and there throughout a community?

We had a situation with, I think—forgive me for saying this—a President's brother that had done something and it did have some influence, and there is a political danger. I can't separate the two.

My question, and I heard your statement that you are going to take a fresh look, but what is bothering me, are we going to take a fresh approach and really look to see what is happening in the small business community also?

Mr. LELAND. I agree with you. The answer has to be yes. To me this is where the problem is.

You have several areas. A lot of the time was spent, and that is what the questions were basically about, on the buying of Treasury bills, notes, et cetera, and that is what is in my testimony. I spent a lot of time on that.

Considering the size of the market, foreign investment can be absorbed. The problem you give is a problem one has to look at.

Mr. WILLIAMS. How are we going to deal with this without letting our people know of the potential danger because the statistics are not available to the public?

Mr. LELAND. We have to make sure we are getting the statistics, if, for instance, you as a Congressman know of a purchase by someone who is foreign. If someone who moves here and becomes an American citizen and a resident and buys it—for example, by people who left Lebanon and became U.S. residents—that does not show us a foreign purchase, and is not a threat. This has always been true.

If somebody is aware of the fact, and I would be interested in it, that somebody is buying a chain of 7-Eleven's, or one store, and is actually a foreign resident and it is not showing up, I would like to check our statistics because they are supposed to show that.

Mr. WILLIAMS. Don't you think that is happening under some type of disguise? I think it is happening. I am aware of one situation in my area, a newspaper, as a matter of fact, that was offered a great amount of cash, and there is no question, from the information we collected, where it was coming from.

That is very influential, not only to any community, but to my community and to our society, so I think we have to warn them of the potential danger that exists. You cannot blame a business man or woman for selling his business, but if you get the message to them that there is a potential political danger here, it could help us all with our problem.

Mr. LELAND. The message must be gotten across to people that this reporting requirement exists.

If you sell anything above the threshold—and we have to examine whether that threshold is too low or high—and the purchase is made from or by any foreign person, that is supposed to be reported.

Now, I have this same qualm about whether or not it is being reported, too. I really do.

Sure, the big brokers and the banks know how to do it, but if it is done by a lawyer in Youngstown, Ohio, and nobody has pointed out to him the fact that there is a law, and penalties for violation, then we should do something about it. We have got to know it, because then we will be aware if there is a threat.

Mr. WILLIAMS. One way to know about it is to tune our society in. The chairman is way ahead of his time. Our society is not concerned about this as much as they should be. We are concerned, and I am sure you are, but our society does not know, and I think a potential danger exists politically which, in the long run, is going to hurt us all.

I will conclude by saying that I am pleased you are reviewing the current policy. I think that is essential.

Five years from now, 10 years from now, we could wake up and find some very serious problems resulting from foreign investment in this country.

Thank you.

Mr. ROSENTHAL. Mr. Neal.

Mr. NEAL. As I understand it, we have two separate kinds of problems we are dealing with here. We have, one, whether or not it is a good idea to require country-by-country reporting in a specific group of countries, the Middle Eastern countries, country-by-country public disclosure of their investments in the United States, and then we have this other problem concerning the aggregate amount of investment in our country and the kinds of investments that are taking place, and so on.

I quite agree with what has been said about that second problem. We all ought to be aware of it and it does seem to me that your Department ought to be the prime source for our information, and that that ought to be public. I also think that the chairman is very farsighted in bringing this to our attention at this time.

Whether it is harmful or not, we need to decide based on the evidence. The aggregate amount of foreign ownership, both of farmland and business assets, is relatively minute at this time, but it is certainly an important area and we ought to be following it. It could have and would have implications for our political system, economic system, and so on, in a number of different ways. I couldn't agree more with this concern, and what I think I hear you saying is that you are going to pursue it and you are going to keep the committee informed of what you learn.

Is that correct?

Mr. LELAND. Entirely correct.

Mr. NEAL. The other question, when this other question first came up several years ago, the Department of the Treasury said that they thought it was in our national interest for a variety of reasons not to report publicly country-by-country investments in the United States in or by the Middle Eastern countries. I am not quite sure whether or not we pledged to the Saudis and others that we would not do that.

Mr. LELAND. My understanding of it is that what we are talking about here is portfolio investment, not direct. We said that that is our policy and we would continue to follow it. It is not a question of a pledge. We get this information through the TIC reporting system. The New York Fed operates as our agent on this. My understanding of it is, we have agreed that we will not give the statistics on any individual depositor—that would be you or some foreign individual; we are not going to say Mr. So-and-so owns so much.

In this case, where giving an individual country would give the individual purchaser, we have followed our policy through on that basis.

Mr. NEAL. When did we agree to do that?

Mr. LELAND. It has been our policy. When the forms are filed, that is the understanding under which the filing is made.

Mr. NEAL. Is there a difference in level? If you say to someone that this is our policy, is that different from saying to someone we agree not to report? Is that different from saying that we pledge not to report? How do you understand the use of the language?

Mr. LELAND. In that sense they are all somewhat alike. How does a government make such an agreement, by a treaty, or executive agreement?

We have a regulation under which these TIC forms are filed. Investors buy these instruments with the understanding that the reporting of information is going to be made, but that we are not going to release information about any one depositor, and that will be it, so they have actually bought it with that understanding. It is not a formal agreement. And if the regulation and the law got changed, release would have to happen, and the investors would have to decide whether they wanted to buy it.

Mr. NEAL. I remember the Department of the Treasury felt strongly about this a number of years ago, that it would not be in our interest to report country-by-country investments by the Middle Eastern countries in this country; that they would report publicly the aggregate investments and kinds of investments, but it seemed to be a serious point that the Department of the Treasury was making at that time, and I am curious if you think it is serious or should we start to report it?

Mr. LELAND. Basically we get the information that we want, and it is available in that form.

Mr. NEAL. What if the subcommittee decides it wants to make public country-by-country data on Middle Eastern country investments?

Mr. LELAND. The law under which we have obtained this information and they invested provides that the information should be kept confidential.

Mr. NEAL. What if the subcommittee does not agree?

Mr. LELAND. They would have to subpena it and find out from the lawyers.

Mr. NEAL. You would think it is important enough not to voluntarily turn it over?

Mr. LELAND. Yes. I think insofar as a purchaser is making a lot of purchases, and you have a general policy of not revealing any depositor, I find the country-by-country information does not add anything.

If you want to take the Middle East oil exporting countries and presume it is all owned by Saudi Arabia, and then discuss the issue, what difference does it make?

That is really my response. If it mattered for the national interest, for instance, on direct investment, and we had a policy that said, "Well, we won't tell you which of the countries it is that is owning something," that would be wrong because there is a need to know which individual country has it.

If the numbers got so large in the aggregate, or if we gave you a number that included too many countries, you would say, "No, we need to know it because what this committee is interested in is the size of the threat." That can be gotten out by the way these figures are given. If it couldn't, one might have to consider changing the regulation. Balancing the desires for privacy, which any depositor has, and the need at this particular time, we would have to keep it confidential.

Mr. NEAL. You feel the information you have is accurate enough, if we were to need any detailed information on a country-by-country basis, in case of some sort of emergency or threat to our national interest, that you could supply it in a timely fashion?

Mr. LELAND. I hope so.

Mr. NEAL. I am asking your opinion, though.

Mr. LELAND. Yes. My opinion is yes.

Mr. NEAL. One more minute, Mr. Chairman.

You say that you would think it important enough not to voluntarily turn it over, you would want the subcommittee to subpena the information, and because of what, again? What is the question?

Mr. LELAND. Unfortunately it is deflecting attention from what is a problem. Here we are talking about an overall investment which is known to be almost all in U.S. Government securities, and we know what the amount is. These people are investing; they are a depositor; and we would just as soon not have anybody know how much they have there.

The need for the specific information for that specific country seems to me not to overbalance, in my looking at it, their desire for confidentiality.

Mr. NEAL. What would be the possible consequences if you were to reveal this information?

Mr. LELAND. I don't know what the specific consequences would be. We said we wouldn't reveal it, and we wouldn't. No one is going to bomb us. I don't know.

Mr. NEAL. Again, I am inclined to agree that there is no particular advantage as long as we know it. If the subcommittee wanted to know, if members of the subcommittee wanted to know on a confidential basis, would you have any hesitancy?

Mr. LELAND. I have to consult with the lawyers on our agreement. There has been some discussion of information that has been broken down even into much smaller groups than what is in the statistics. I don't know. I would have to really defer to them on that one.

Mr. NEAL. Thank you, Mr. Chairman.

Mr. ROSENTHAL. Thank you very, very much.

I have a whole lot of other things I would like to talk to you about, but Governor Wallich has been sitting here. We do want you to know we intend to pursue this matter with vigor and diligence, and we would hope within 3 to 6 months you would be in a position to say that you, yourself, are or are not satisfied with the reporting system and perhaps you could give us within 3 to 6 months an update on what the totality of investments are and we can talk about some of these other issues at that time.

Also, I wonder if you could find out if anybody in Treasury or Commerce has any kind of projection or prognosis of total OPEC investments or surpluses for the next 5 years, for example. Does anybody have or is anybody working on anything like that?

Mr. LELAND. As you know, a lot of people work on a lot of statistics, and they often do not come out right, but there are some projections. They probably do it based upon different oil prices—and not knowing what that is going to be—based upon the assumption and what they think the absorptive capacity of those countries is. As a result of these assumptions they can estimate what will be available as a surplus.

Mr. ROSENTHAL. Going back to a very minor technical problem, do you know of any other Government agency that has American nationals on the payroll being paid on a reimbursible basis by a foreign government?

Mr. LELAND. I know that there are a lot of reimbursable detail situations in the U.S. Government where they work for the Government, and they are reimbursed by somebody else, and there are some where the reimbursement comes directly——

[Additional information submitted by Mr. Leland follows:]

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

OCT 1 1981

Dear Mr. Chairman:

In your Subcommittee Hearings on September 23, you asked if any other U.S. Government agencies are being compensated for providing technical assistance to foreign countries. In response, under Section 607 of the Foreign Assistance Act of 1961, over 25 U.S. Government agencies have provided assistance to over 40 friendly foreign countries and international agencies. This section authorizes U.S. Government agencies to furnish commodities and services to friendly countries on an advance-of-funds or reimbursable basis. Soviet Bloc countries are specifically excluded from the definition in the Foreign Assistance Act of friendly country.

Reimbursable technical assistance programs are directed principally at those countries that can finance their own development either through domestic resources or access to international financing. Initially AID and presently the Trade and Development Program (TDP), a component of the International Development Cooperation Agency, serves as the coordinating and authorizing agency for other U.S. Government agencies to provide technical assistance to developing countries on a reimbursable basis. For example, AID has a reimbursable program with Nigeria which provides full-time services of USG personnel to coordinate the technical training of 2,500 Nigerian students in U.S. institutions. Other examples of reimbursable programs involving full-time USG personnel are Federal Highway Administration projects with Kuwait and Costa Rica; Department of Labor projects with Bahrain and Paraguay; and Bureau of Reclamation projects with Zaire, Malaysia and Sri Lanka. Costa Rica, Paraguay, Zaire and Sri Lanka fund their programs with loans from the Inter-American Development Bank and the World Bank.

Enclosed are copies of the FY 1982 Congressional Presentation of TDP, which includes a list of countries receiving reimbursable technical assistance through the first quarter of 1981, and a brochure which describes TDP activities. I trust this information will serve to describe the extent of reimbursable U.S. Government technical assistance programs.

Sincerely,

Marc E. Leland
Assistant Secretary for
International Affairs

The Honorable
Benjamin S. Rosenthal
Chairman, Commerce, Consumer and
Monetary Affairs Subcommittee of the
Committee on Government Operations
House of Representatives
Washington, D.C. 20515

Enclosures

[Enclosures may be found in the subcommittee files.]

Mr. ROSENTHAL. We are going to ask the GAO to give us an opinion as to whether your department may be in violation of the law. I, myself, think they are.

Thank you very, very much for a very thoughtful presentation.

[The annex to Mr. Leland's statement follows:]

ANNEX

RESPONSE TO THE SUBCOMMITTEE'S

QUESTIONS IN THE LETTER TO

MR. LELAND OF JULY 15, 1981

QUESTION: We require information about the amounts of investible OPEC surpluses, their distribution by country and types of investments, and unidentified flows of such surpluses:

1. We require a comparison of estimates as to the disposition of the OPEC current account surpluses as of December 1980, with figures for both dollar and non-dollar assets. Treasury estimates should be compared with those of the Bank for International Settlements (BIS), Organization of Economic Cooperation and Development (OECD), International Monetary Fund (IMF), Bank of England, the Federal Reserve, the CIA, Chase, Bankers Trust, and Morgan Guaranty. (If certain estimates are not available to that date, please furnish the latest available estimate from that entity.)

   Set forth these estimates on total OPEC investible surpluses. In an appendix to your testimony, estimates should be broken down in a fashion similar to Table 1, furnished to us on July 2, 1981, modified as follows: only one figure needs to be given for the United States and separate figures should be additionally provided for Germany, Japan, Switzerland, and France, and off-shore facilities (such as Luxembourg, the Cayman Islands, and the Netherlands Antilles).

2. To what extent do Treasury's estimates vary from those of other agencies or entities? If so, why?

3. We are concerned about unidentified OPEC investible surpluses, differing estimates about them, and the reasons for them. Our concern is based on the following:

   During a speech in March 1980 at New York University, Federal Reserve Chairman Volcker reported that as of year end 1979, there was approximately $75 billion that had not been identified as foreign official holdings of OPEC and that this amount was invested in ways that our statistics did not pick up. In your July 2, 1981, submission to us, you estimate this discrepancy to be $37.75 billion.

   Two U.S. Government documents discuss the problem of unidentified OPEC surpluses.

   A November 23, 1977, Treasury memo to a Treasury assistant secretary (Doc. No. E 11), furnished to the subcommittee states:

   > Knowledgeable persons who handle these accounts have told us that most OPEC countries, including [country name deleted] do not give them a breakdown of the types of foreign exchange reserves which they hold; however, it is their opinion that these countries have been underreporting their holdings for political purposes. Our figures seem to provide substantial evidence for this assumption.

Closely related, a summary of a State Department document (Doc. No. 15), attached, discusses a discrepancy:

> The Department noted that USG [U.S. Government] analysts had predicted a Saudi current account surplus of $21 billion for 1977 and could not, from the limited figures available to them, identify offsetting movements in the capital account which would explain the gap between the U.S. estimates of current account surplus and the reported additions to SAMA's [Saudi Arabian Monetary Agency] assets.
>
> ...It is doubtful, however, if [Saudi] government aid transfers could account for the entire $8 billion discrepancy [for 1977] between current account figures and SAMA's.

a. What do each of the other entities and agencies, in particular the Federal Reserve, BIS, OECD, IMF, and the CIA, estimate the cumulative total <u>unidentified</u> OPEC investible surplus to be? To the extent their estimates are larger than Treasury's $37.75 billion estimate, what is the reason for that?

b. Explain fully why it is not possible to accurately identify all OPEC surpluses? What categories of investible surpluses do Saudi Arabian and the Kuwaiti governments' underreport or fail to report? Are there problems with other OPEC government's reported statistics?

c. What steps specifically has the U.S. Government taken to improve the accuracy of OPEC surplus data? What discussions has the U.S. Government had with other countries, both OPEC and non-OPEC, about this matter and with what results?

4. Closely related, the CIA has estimated the size and distribution of OPEC official foreign assets. A February 18, 1977, FED memo, "Getting more data on OPEC investment flows", attached, states:

> The CIA data also have some holes in them for unidentified flows. But they do purport to identify much more than we do. I think it would be worthwhile to explore with CIA the possibility of their furnishing us with more up-to-date information. Treasury should also want more information.
>
> ...[The document compares CIA figures with Fed figures]. CIA also comes up with a not insignificant amount of gaps to fill....But this $3.9 billion gap [which the CIA cannot explain] is only 16 percent of the $23.7 billion of current account surplus and borrow proceeds to be accounted for, a much smaller residual than we get.

a. How have CIA estimates compared with Treasury's for each year 1974 to the present? (Furnish the figures for each year.)

b. Please explain how CIA was able to find all but $3.9 billion for the period involved, while the Federal Reserve and Treasury were not able to account for a much larger amount.

c. Has Treasury accepted or rejected CIA's figures in making its final estimates? If it has rejected them, why?

ANSWER: Figures presented below were prepared by Treasury staff based on published figures or figures provided to Treasury in August. These figures may not represent official views of the institutions listed and do not incorporate any subsequent revisions.

Table 1

Estimates of Cumulative OPEC Current Account Surplus: ($ billions)

	1974-1980
Bankers Trust 1/	311
Chase 1/	331
Morgan Guaranty 1/	318
IMF	357
CIA 1/	321
OECD	361 1/2
BIS	360
Bank of England 1/	328
Federal Reserve Board 1/	337
U.S. Treasury 2/	357 3/4

1/ After official transfers. (N.B. Dates of estimates and revisions vary. Current account figures are estimates of current receipts less expenditures for goods, services and transfers (grants) summed for individual OPEC countries vis a vis all other countries worldwide. Current account estimates are reduced to the extent they include official transfers.)

2/ Estimate before official transfers. Estimate after official transfers (of $33 3/4 billion) is $324 billion.

Table 2
Estimates of the "Disposition" of OPEC Investible Surplus: Identified Placement of Assets and Official Transfers
($ billions)

	Cumulative 1974-1980									
	U.S. Treasury 1/	Bank of England 2/	BIS 2/	IMF 1/ 3/	Chase 2/ 4/ (unpublished)	Bankers Trust 2/ 5/	Morgan Guaranty	OECD	CIA	Federal Reserve Board
United States	59 1/2	65	61 3/4		57 1/4					
United Kingdom	13 3/4	12 1/2		328	13					
Eurobanking Market other developed and non-market countries	191 1/2		245 1/4		220 1/4	n.a.				
Less developed countries	54 1/2	241		52						
International financial institutions, gold	13 1/4		14 1/2	8	13 1/4					
Grand total	332 1/2	318 1/2	321 1/2	388	304	336	n.a.	n.a.	n.a.	n.a.

n.a. Not available.
1/ Total includes official transfers (grants) to LDCs. Treasury estimates include cumulative official transfers of $33 3/4 billion.
2/ Total excludes official transfers (grants) to LDCs.
3/ Total includes statistical discrepancy consisting of errors and omissions on current and capital accounts.
4/ Covers 1974-Sept. 1980. Source is a draft paper prepared by Dr. Sharif Ghalib, Vice President and Middle East Economist, Chase Manhattan Bank. The paper does not necessarily reflect views of the Chase Manhattan Bank.
5/ Figure indicates "net foreign exchange income", which is equal to a cumulative current account estimate, as published in Euromoney, Sept. 1980 in an article by Susan Bluff, Assistant Vice President, Bankers Trust Company, London. Table 1, above, includes a comparable revised figure provided by Bankers Trust Company, New York.

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IMB

Table 2

The disposition of investible surplus in general shows the geographic location of identified official and private OPEC placements (capital flows) at estimated transactions values. Cumulative figures that exclude estimated official transfers (which are included in Treasury and IMF estimates) will give an approximate estimate of OPEC investments outstanding at the end of the period but would not, for example, include changes in the stock of assets reflecting changes in exchange rates, nor would they include investments made prior to 1974 that would be included in estimated OPEC holdings of foreign assets.

Treasury does not regularly prepare estimates disaggregated into dollar/non-dollar components.

Cumulative OPEC placements in Germany during 1974-1980, estimated from data published by the Bundesbank, are $18.5 billion. Japan, Switzerland, France, Luxembourg, the Cayman Islands and Netherlands Antilles do not to our knowledge publish data for OPEC investments in those countries.

Annual Treasury estimates for the period 1974-1980 and other estimates in Table 2 do not normally include separate disaggregations for investments in individual countries other than the United States and the United Kingdom.

Estimates of identified OPEC placements were not available from the following organizations:

Morgan Guaranty. Current estimates for the 1974-1980 period are not available, although in the past Morgan has published figures for the disposition of OPEC investible surplus. In May 1981, Morgan's World Financial Markets reported that OPEC net external assets were estimated to be $327 billion at the end of 1980. (Net external assets consist of gross government and private assets minus their external obligations.)

OECD. To our knowledge the OECD does not provide estimates of the disposition of OPEC surpluses.

CIA. Annual estimates of official and private OPEC placements for the time period requested have not been prepared on a basis comparable to the estimates given in Table 2.

The Federal Reserve Board. The Fed does not normally prepare independent estimates of the disposition of OPEC investible surplus, and no comparable time series from 1974-1980 in the detail given in Table 2 was available.

Table 3

Estimates of Investible Surplus:
Surplus Available to Invest 1/
($ billions)

	Cumulative 1975-1979	Cumulative 1974-1980
Bank of England	203	374
CIA	184	n.a.
U.S. Treasury	202 1/2	389 1/2
IMF	210	388

1/ Surplus available for investment in general consists of current account surplus with an adjustment to reflect the timing of oil receipts, which is affected by changes in credit terms given by oil exporters; plus OPEC borrowings.

(N.B. Treasury and IMF current account estimates are before official transfers; Bank of England and CIA estimates are after official transfers.)

Table 4

Discrepancy of Estimates: Investible Surplus
Less Identified Placements 1/
($ billions)

	Cumulative 1974-1980
Bank of England	55 1/2
U.S. Treasury	57
IMF 2/	0

1/ Data in Table 3 less data in Table 2.
2/ Estimated placements include errors and omissions on current and capital accounts.

Errors and Omissions on Current and Capital Accounts

To our knowledge the Federal Reserve Board, BIS, OECD, and IMF do not normally calculate the discrepancy between estimates of investible surplus and estimates of the identified disposition of OPEC surpluses as official and private placements.

The discrepancy of $75 billion cumulative from 1974-1979 noted by Chairman Volcker in his March 1, 1980 speech is larger than was Treasury's $37.75 billion estimate for the same period primarily because Fed data did not include estimates of OPEC non-bank placements in "other" developed, non-market, and less-developed countries, or OPEC purchases of gold, as shown in Table 2.

A change in the treatment of OPEC debt repayment included in Treasury estimates does not affect the discrepancy. Treasury's 1975-1977 data for the disposition of OPEC surpluses include repayment of principal on OPEC debt. After 1977, debt repayments are netted against new borrowing in calculating available investible surpluses.

Treasury's cumulative discrepancy equals 15 percent of the total estimated investible surplus available for 1974-1980. The discrepancy probably includes some unidentified assets in markets outside the United States where information is less complete than are the data for investments, both official and private, in the United States. Subsequent analysis of the current account surplus and adjustments may tend to reduce the 1980 discrepancy, as have previous downward revisions that have been made when more complete trade data are available. Other factors that may contribute to the discrepancy are differences in timing and valuation of transactions, and some underestimation of OPEC debt repayment.

The Fed's memorandum of February 18, 1977, mentioned in the Chairman's letter, compares Fed numbers with those of the CIA, but not Treasury estimates. For the entire year in question, Treasury calculates a discrepancy that is smaller than $3.9 billion. That calculation is provided in the attached Treasury table showing the disposition of OPEC investible surplus.

Differences between the "discrepancy of estimates" calculated by the Bank of England and by Treasury are difficult to identify. The estimates of investible surplus and identified placements prepared by the Bank of England and the Treasury each show small differences in individual years. Estimates of placements in the United States differ because Bank of England data do not include the most recent revisions to U.S. data. Another area of difference is likely to be in the calculation of flows to less developed countries. Treasury estimates that OPEC placements of $332 billion include $33 3/4 billion of estimated official transfers to less developed countries. When adjusted to exclude these flows, Treasury estimates that OPEC investment in external assets in the 1974-1980 period approached $298 3/4 billion compared to $318 1/2 billion (excluding official transfers of $19 billion) estimated by the Bank of England. It is frequently difficult to determine whether flows to LDCs are grants (official transfers) rather than loans, or whether commitments to lend to LDCs have actually resulted in disbursements. Judgments based on incomplete information will affect these estimates and may account for differences in the total flows to LDCs attributed to current and capital accounts.

OPEC and other members of the International Monetary Fund are required to furnish it with such information as it deems necessary for its activities (Article VII, Section 5), including data on foreign exchange holdings by official entities and by non-official banking and financial agencies. The Fund publishes summary data in its International Financial Statistics and more extensive detail in its Balance of Payments Yearbook. With respect to data on official reserves, there is some leeway as to the definition of assets constituting reserves. The Fund has established guidelines concerning balance of payments accounting; however, the degree to which reports are made on a timely basis and in conformity with the guidelines varies considerably among member countries. The Fund must take into account members' ability to provide data, and members are under no obligation to furnish information that would reveal the activities of individuals or corporations.

The USG devotes considerable effort to the improvement of information on OPEC financial activity. Treasury and CIA independently estimate OPEC investments and frequently consult with one another, although it should be emphasized that the focus on the efforts of the two agencies differs in that CIA primarily attempts to identify official investments while Treasury estimates placements by all residents of the OPEC countries.

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Estimated Disposition of OPEC Investible Surplus
1974-1980
($, billions)

	1974 r	1975 r	1976 r	1977 r	1978 r	1979 r	1980 p	Cumulative 1974-1980
United States	11.5	7.9	11.1	7.4	.4	7.1	14.0	59.5
of which:								
Treasury securities:								
Bills and certificates	5.3	.5	-1.0	-.9	-.9	3.3	1.4	7.7
Bonds and notes	.2	2.0	4.3	4.3	-1.5	-1.2	8.2	16.3
Other marketable U.S. bonds	.9	1.6	1.2	1.7	.8	.4	3.5	10.1
U.S. stocks	.2	1.7	1.8	1.4	.8	.7	1.2	7.8
Commercial bank liabilities	4.2	.6	1.9	.4	.8	5.1	-1.2	11.8
Subtotal (banking and portfolio placements)	10.7	6.3	8.1	7.0	0.0	8.4	13.1	53.6
Other (direct investment, prepayment for U.S. exports, placements in nonbanks)	.7	1.7	3.0	.5	.4	-1.2	0.9	6.0
Euro-banking market	22 1/2	8	11	12	2 1/2	29	32	117
United Kingdom 1/	7 1/2	1/4	-1	3/4	1/4	2 1/2	3 1/2	13 3/4
Other developed and Non-market countries	6 1/2	9 3/4	9 1/4	9 1/4	5 3/4	8 1/4	25 3/4	74 1/2
Less developed countries 2/	6	7 1/4	7 1/2	8 1/2	6 1/2	8 1/2	10 1/4	54 1/2
International financial institutions, IMF Position, SDRs, Gold	3 3/4	4 1/4	1 1/4	1/2	-1/2	-1/2	4 1/2	13 1/4
TOTAL ALLOCATED	57 3/4	37 1/2	39	38 1/2	15	54 3/4	90	332 1/2
Current account surplus	72 1/4	36 3/4	39	31 1/2	-1	63 1/4	116	357 1/2
Lag in receipt of oil revenues	-11 1/4	-1/4	-7 1/2	2 1/2	-2 1/4	-7 3/4	5 1/4	-21 1/4
Net borrowings	1/2	3 3/4	7 3/4	9 3/4	18 3/4	8 1/4	4 1/4	53
INVESTIBLE CASH SURPLUS	61 1/2	40 1/4	39 1/4	43 3/4	15 1/2	63 3/4	125 1/2	389 1/2
DISCREPANCY (Cash surplus less allocated surplus)	3 3/4	2 3/4	1/4	5 1/4	1/2	9	35 1/2	57

r Revised. Detail may not add to totals due to rounding.
1/ Excludes foreign currency deposits which are included in Eurobanking market.
2/ Includes grants.

Treasury Department
IMB
9/10/81

QUESTION: Relying on the most recently available data, set forth, for each category of investment, Treasury's latest estimates of (a) all Middle East OPEC investments and holdings in the United States and (b) all remaining non-Middle East investments in the United States. (Additionally, please append to your testimony the tables furnished to us on July 2, 1981.) How much of this investment is long-term (one year or more) and how much is short term?

ANSWER: In the following tables, data for Treasury bonds and notes, Federal agency issues and corporate bonds indicate foreign holdings of securities that have an original maturity of more than one year. Treasury bills and certificates have an original maturity of one year or less. Portfolio holdings of corporate stocks are marketable instruments having no fixed maturity. Demand deposits with commercial banks are of course short term. Each of the other categories in the table includes instruments with a mix of original maturities or liabilities with no specific maturity. For example, liabilities shown as commercial bank liabilities other than deposits, which are reported primarily by banks but include as well foreign holdings in custody accounts of stock brokers and security dealers, include a variety of instruments with a mix of original maturity terms. Such instruments are primarily short term and include money market instruments, certificates of deposit, government agency securities of less than one year, and liabilities from repurchase agreements. No maturity distribution for such holdings is maintained.

Treasury dropped the distinction between "long term" and "short term" from the TIC B and C series forms several years ago in line with general recommendations by the Advisory Committee on the Presentation of Balance of Payments Statistics.

MIDDLE EAST OIL EXPORTERS: Investments in the United States ($ millions)

	Capital Flows								Investment Position		
	1974	1975	1976	1977	1978	1979	1980	Jan-June 1981	End Dec. 1979	End Dec. 1980	End June 1981
U.S. Government securities	3,176	4,368	4,857	4,676	-2,504	2,455	9,173	7,593	15,770	24,943	32,537
Treasury bills & certificates	2,092	1,504	209	- 733	- 837	3,552	51	1,273	5,868	5,919	7,193
Treasury bonds & notes	200	1,797	3,887	4,451	-1,785	-1,014	7,672	5,230	6,954	14,626	19,856
Federal agency issues	884	1,067	761	958	118	- 83	1,450	1,090	2,948	4,398	5,488
Corporate bonds	0	488	418	737	691	507	2,049	1,238	2,788	4,837	6,075
Corporate stocks	216	1,649	1,803	1,390	781	688	1,206	389	6,702	7,908	8,297
Commercial bank liabilities	1,979	1,133	1,796	352	- 605	4,232	- 897	-599	9,454	8,556	7,957
Demand deposits	n.a.	90	77	603	55	1,314	- 324	-42	2,613	2,289	2,248
Time deposits 1/	n.a.	- 376	107	- 42	406	73	29	-16	667	696	680
Other	n.a.	1,419	1,612	- 209	-1,066	2,845	- 602	-541	6,173	5,571	5,030
Subtotal 2/	5,371	7,638	8,874	7,155	-1,637	7,882	11,531	8,621	34,714	46,244	54,866
Nonbank liabilities 2/	432	500	227	167	43	- 506	-116	67 5/	1,048	931	998
U.S. Government liabilities 3/ 4/	149	922	2,444	396	14	-1,075	651	-152	2,980	3,631	3,478
Direct investment 3/	77	6	- 15	- 13	100	16	198	39	321	520	559
Total investment in the U.S.	6,029	9,066	11,530	7,705	-1,480	6,317	12,264	8,575	39,063	51,326	59,901

n.a. not available. P Preliminary.
1/ Excludes negotiable time certificates of deposit, which are included in "Other" liabilities.
2/ Iran, Iraq, Kuwait, Qatar, Saudi Arabia, UAE, Bahrain and Oman.
3/ Excludes Bahrain and Oman.
4/ The position consists of cumulative flows from 1972.
5/ First quarter data.
Note: Detail may not add to total due to rounding.
Source: Treasury International Capital Reports; Department of Commerce.

Treasury Department
Office of International Banking & Portfolio Investment
September 16, 1981

NON-MIDDLE EAST OIL EXPORTERS: Investments in the United States
($, millions)

	CAPITAL FLOWS								INVESTMENT POSITION: END OF PERIOD		
	1974	1975	1976	1977	1978	1979	1980	Jan-June 1981 P	Dec. 1979	Dec. 1980	June 1981
U.S. Government Securities	3,183	-876	-887	-250	193	-316	1,845	-812	1,338	3,138	2,369
Treasury bills & certificates	3,188	-1,046	-1,253	-119	-101	-211	1,329	-1,027	769	2,098	1,071
Treasury bonds & notes	-5	170	366	-131	286	-105	516	215	568	1,084	1,299
Federal agency issues	0	0	0	0	8	0	0	0	1	1	1
Corporate bonds	2	10	1	-1	11	1	0	3	65	65	72
Corporate stocks	3	3	25	18	11	-16	-4	3	172	168	173
Commercial bank liabilities	2,179	-504	107	49	1,397	851	-263	187	5,991	5,729	5,914
Demand deposits	n.a.	-46	725	-275	-129	616	266	153	2,029	2,295	2,477
Time deposits 1/	n.a.	-138	-595	60	474	147	9	171	1,519	1,528	1,700
Other	n.a.	-320	-23	264	1,052	88	-538	-139	2,444	1,906	1,736
Subtotal 2/	5,367	-1,367	-754	-184	1,612	520	1,578	-621	7,566	9,145	8,528
Nonbank liabilities	62	254	288	-159	175	198	222	-23	969	1,192	1,164
U.S. Government liabilities	-17	22	36	-4	37	87	-25	-4	171	146	143
Direct investment	34	-38	9	3	10	3	-1	3	64	56	58
Total investment in the U.S. 2/ 3/	5,446	-1,129	-421	-344	1,834	808	1,774	-650	8,770	10,539	9,893

n.a. not available. P Preliminary.
1/ Excludes negotiable time certificates of deposit which are included in "other" liabilities.
2/ Venezuela, Indonesia, Ecuador, Algeria, Gabon, Libya, Nigeria.
3/ Data represent the difference between data for oil exporters and Middle East oil exporters presented in separate tables.
SOURCE: Treasury International Capital Reports; Department of Commerce
Note: Detail may not add to total due to rounding.

Treasury Department
Office of International Banking & Portfolio Investment
9/16/81

OIL EXPORTERS: Investments in the United States ($ millions)

	Capital Flows								Investment Position		
	1974	1975	1976	1977	1978	1979	1980	Jan-June 1981	End Dec. 1979	End Dec. 1980	End June 1981
U.S. Government securities	6,359	3,492	3,970	4,426	-2,311	2,139	11,018	6,781	17,108	28,126	34,906
Treasury bills & certificates	5,280	458	-1,044	- 852	- 938	3,341	1,380	246	6,637	8,017	8,264
Treasury bonds & notes	195	1,967	4,253	4,320	-1,499	-1,119	8,188	5,445	7,522	15,710	21,155
Federal agency issues	884	1,067	761	958	126	- 83	1,450	1,090	2,949	4,399	5,489
Corporate bonds	2	498	419	736	702	508	2,049	1,241	2,853	4,902	6,147
Corporate stocks	219	1,652	1,828	1,408	792	672	1,202	392	6,874	8,076	8,470
Commercial bank liabilities	4,158	629	1,903	401	792	5,083	-1,160	-414	15,445	14,285	13,871
Demand deposits	n.a.	44	802	328	- 74	1,930	- 58	111	4,642	4,584	4,725
Time deposits 1/	n.a.	- 514	- 488	18	880	220	38	155	2,186	2,224	2,380
Other	n.a.	1,099	1,589	55	- 14	2,933	-1,140	-680	8,617	7,477	6,766
Subtotal 2/	10,738	6,271	8,120	6,971	- 25	8,402	13,109	8,000	42,280	55,389	63,394
Nonbank liabilities 2/	494	754	515	8	218	- 308	106	39 5/	2,017	2,123	2,162
U.S. Government liabilities 3/ 4/	132	944	2,480	392	51	- 988	626	-156	3,151	3,777	3,621
Direct investment 3/	111	- 32	- 6	- 10	110	19	197	42	385	576	617
Total investment in the U.S.	11,475	7,937	11,109	7,361	354	7,125	14,038	7,925	47,833	61,865	69,794

n.a. not available. P Preliminary
1/ Excludes negotiable time certificates of deposit, which are included in "Other" liabilities.
2/ OPEC plus Bahrain and Oman.
3/ OPEC.
4/ Position consists of cumulative flows from 1972.
5/ First quarter data.
Note: Detail may not add to total due to rounding.
Source: Treasury International Capital Reports; Department of Commerce.

Treasury Department
Office of International Banking & Portfolio Investment
September 16, 1981

OPEC: Current Account
($ billion)

	1978	1979	Estimate 1980 2/	Projections 1/ 1981	Projections 1/ 1982
Oil Exports Earnings 3/	131	198	279	255	267
Non-Oil Exports (f.o.b.)	11	16	17	22	27
Imports (f.o.b.)	-104	-108	-135	-153	-182
Trade Balance	38	106	161	124	112
Services credits	23	26	37	55	65
Services debits	-56	-61	-73	-87	-106
Private transfers (net)	-6	-7	-9	-10	-11
Current Account Balance (excl. official transfers)	-1	63	116	82	60
Official Transfers (net)	-4	-5	-9	- 9	-10
Current Account Balance	-5	58	107	73	50
Current Account Position of OPEC:					
Countries in Surplus	13	61	107	93	67
Countries in Deficit	18	3	0	20	17

1/ The projections assume a constant nominal average OPEC price throughout the remainder of 1981 and extending through 1982. The export weighted average 1981 price including premiums is about $34.48/bbl, 11.2% above the 1980 level. Average 1981 OPEC oil production including natural gas liquids is projected at 23.4 mmb/d with average oil exports of 20.5 mmb/d. The average 1982 price is $34.46 bbl (nearly the same as 1981). Oil production in 1982 is projected at 24.5 mmb/d with average exports of about 21.4 mmb/d.

2/ The estimated average 1980 OPEC oil price was about $31 (including premiums) or 67 percent above the $18.59 average 1979 level. Average 1980 OPEC oil production (including ngls) was at 27.7 mmb/d, with exports of about 24.9 mmb/d.

3/ Oil export revenues less foreign oil company profits earned in OPEC countries

4/ Items may not add due to rounding.

TREASURY DEPARTMENT
IDN
September 21, 1981

OPEC: Current Account Balances
($ billion)

	1978	1979	Estimate 1980
Algeria	-3.9	-2.1	.8
Ecuador	- .7	-.6	-.2
Gabon	- .1	.2	.5
Indonesia	-2.0	.7	4.5
Iran	-2.4	8.5	.2
Iraq	3.4	10.8	10.5
Kuwait	5.9	14.1	15.5
Libya	.1	4.7	8.8
Nigeria	-3.8	1.2	3.3
Qatar	.6	2.0	4.1
Saudi Arabia	.9	14.4	46.5
UAE	2.5	4.8	8.3
Venezuela	-5.7	-.3	4.4
Total	-5.3	58.4	107.4

Items may not add to totals due to rounding.

TREASURY DEPARTMENT
IDN
September 21, 1981

QUESTION: A November 1978 Chase Economic Group publication, furnished by Treasury, (Doc. No. 85, File IM6-3-b) states that as of the end of August 1978, "the bulk of OPEC portfolio holdings were held by Saudi Arabia". Is this true today? Is Kuwait still number two? What other OPEC countries are in a surplus position with the United States?

ANSWER: We understand from the Subcommittee's staff that it wishes to have a ranking by the amount of total holdings of each OPEC country.

We are unable to comply with the request. Divulging the ranking requested, either for all OPEC countries or for selected members, would constitute disclosure of the holdings of an individual foreign investor contrary to the International Investment Survey Act of 1976 and the Bretton Woods Agreements Act. First, since the holdings of three OPEC countries are published, any ranking that included one of these countries as well as one of the Middle East or African oil exporters would result in the placement of an upper or lower bound, or both, on the holdings of the latter. Second, a ranking would enable any of the countries whose holdings are not published to judge whether the other countries' holdings are higher or lower. In conjunction with the published holdings of country groupings, fairly close estimates would in many cases be possible. This ability would be enhanced if two or more countries shared information on their holdings so as to estimate the holdings of a third. Third, a ranking would provide an additional element of information which could be drawn upon in conjunction with information from sources other than Treasury's statistical reporting system to refine crude estimates sufficiently to approximate the unpublished holdings.

QUESTION: How much cumulative interest has the U.S. Treasury paid to OPEC countries holding U.S. securities from 1974 to the present? If this information is known only for securities sold through the Add-On facilities, then furnish that figure and explain why Treasury fails to keep the remainder of this information.

On all other investments in the United States, how much cumulative income has OPEC earned from 1974 to the present in (1) dividends, (2) interest, and (3) other payments?

ANSWER: The total estimated interest payments to oil exporting countries on their holdings of U.S. public debt securities is $5,599.5 million for the calendar years 1975-1980 inclusive. Following is a table giving more detail. The figures for 1974 are not readily available. The estimate is for both foreign official and foreign private holdings.

Cumulative OPEC earnings from 1974 through 1980 were $1.2 billion in stock dividends, $1.0 billion in corporate interest, and $5.5 billion in other private interest payments. The data, prepared by the Bureau of Economic Analysis, U.S. Department of Commerce, are estimates, not exact tabulations.

Estimated Interest Payments on Foreign Holdings of Public Debt Securities
Calendar Years 1975-1980
(Millions of dollars)

	1975 Interest	1976 Interest	1977 Interest	1978 Interest	1979 Interest	1980 Interest
Argentina	1.5	5.5	5.5	12.0	6.0	6.5
Australia	158.5	85.5	64.5	39.0	36.5	63.0
Austria	12.0	8.5	8.0	9.0	5.5	1.5
Belgium	115.5	59.5	71.5	71.0	70.5	113.0
Canada	238.0	228.0	171.0	144.5	209.0	200.0
Denmark	15.5	18.5	40.0	77.5	94.0	35.0
France	270.0	207.5	174.0	346.0	645.0	829.5
W. Germany	1,391.5	1,329.5	1,435.5	2,214.5	2,894.0	3,020.0
Italy	69.5	32.0	144.5	288.0	468.0	398.0
Japan	604.0	659.5	779.5	1,739.5	1,853.0	1,758.0
Mexico	2.0	3.0	1.5	2.0	2.0	3.0
Netherlands	174.0	121.0	131.0	189.5	222.5	243.5
Norway	20.0	27.5	36.0	61.0	51.5	51.0
Spain	*	*	*	*	9.5	14.5
Sweden	108.5	109.0	92.0	183.5	191.0	173.0
Switzerland	237.5	263.5	274.0	607.0	1,143.5	723.5
Thailand	8.5	6.5	14.0	18.5	18.0	18.0
United Kingdom	108.0	71.0	387.5	624.5	564.0	761.0
Oil Exporting Countries	300.0	600.0	791.5	874.0	919.0	2,115.0
International	136.0	241.0	288.5	332.5	327.0	384.0
All Other	279.0	182.0	295.5	364.5	754.5	566.5
Total**	4,250.5	4,258.5	5,205.5	8,198.5	10,484.0	11,477.5

Office of the Secretary of the Treasury
Office of Government Financing

March 12, 1981

* Less than $.5 million
** Totals may not add due to rounding

QUESTION: In August 1980, the subcommittee issued a report evaluating Federal efforts to monitor foreign direct investment in the United States. We are now assessing Federal efforts to monitor foreign portfolio investment (both OPEC and non-OPEC) in the United States. Accordingly, we require certain information bearing on the effectiveness of the Treasury International Capital survey system and the recent Treasury Foreign Portfolio Investment Survey.

In its December 19, 1979, report, "Changes Needed to Improve Government's Knowledge of OPEC Financial Influence in the United States", the U.S. Comptroller General recommended (a) that the Treasury collect TIC Form S data identifying the sector and industry of equity purchases and (b) that this and other TIC data be published at least annually in a format similar to other published investment statistics. GAO concluded that fears about OPEC investment could not be dismissed without such information and other improvements and it stated:

> This additional information would permit timely and regular identification of the areas of the U.S. economy into which foreign portfolio investment, including that of OPEC, is flowing.

What has Treasury done to implement these recommendations? If they have not been implemented, why not? Is not such information necessary to understanding whether investments are occurring in national interest sectors?

ANSWER: At the time the GAO report was prepared, the Treasury took issue with the GAO's recommendation that Treasury collect sectoral data on foreign purchases of U.S. equities on Form S of Treasury's International Capital Movements reports. At that time we challenged the GAO's view that such a step would permit the GAO to "assess definitively" the extent to which OPEC investments in the U.S. may provide those countries with the "ability to wield undue influence." As we noted, the GAO's statement that "this additional information will permit timely and regular identification of the areas of the U.S. economy into which foreign portfolio investment including that of OPEC is flowing," is merely definitional. These views were transmitted to Congress in a letter from former Assistant Secretary of the Treasury C. Fred Bergsten to the Chairmen of the Oversight Committees in the Senate and the House, a copy of which follows.

We continue to oppose collection of sectoral information on the S forms. Such data are already collected quinquenially under the benchmark survey. Monthly or annual reporting would substantially increase the reporting burden on the private sector, and require an increase in governmental expenditures without producing any significant benefit to either the government or the private sector.

It has still not been demonstrated how the GAO's recommendation would permit an assessment of foreign influence in the United States.

In conclusion, we believe that our existing data collection efforts are adequate for analysis and policy formulation and that expansion of reporting as recommended by the GAO is unwarranted.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

MAR 5 1980

Sent Spec. Mess. 10 A.M.

Dear Mr. Chairman:

This letter reports to you Treasury's response to recommendations of the General Accounting Office that were made in the report, "Changes Needed to Improve Government's Knowledge of OPEC Financial Influence in the United States," dated December 19, 1979.

The GAO recommended that Treasury collect and publish at least annually data that identify the U.S. sector and industry of portfolio investments by foreign investors.

Treasury currently collects and publishes data every five years on foreigners' portfolio holdings in various U.S. industries. These are obtained in benchmark surveys authorized by the International Investment Survey Act of 1976. To require in addition annual reporting of foreign portfolio purchases by industry, as GAO recommends, would substantially increase the reporting burden already imposed on private business.

The GAO contends that "annual reporting would be easier and less expensive than accumulating data every five years." This view reflects a misunderstanding of the reporting we now require. No cumulative information on foreign purchases and sales of U.S. securities by industry is reported to Treasury in its benchmark surveys; rather U.S. securities held by foreigners are reported as of a particular point in time. Although reporters may consider it easier to provide data on portfolio flows than to provide with the same frequency, data on holdings, it is unlikely that they would find annual reports on flows less costly than one report every five years on holdings.

The Treasury believes that additional reporting is not needed because the industry distribution of foreign portfolio equity investments is of limited utility. For this reason, Treasury believes that the data should not be obtained more frequently than is now obtained through the periodic benchmark surveys.

The GAO has not explained why the additional information is needed or how it would be used. The implication of this report is, however, that the additional information would enable the Government to improve its knowledge of OPEC financial influence, that the data would reveal the intent of investors, and that it would give the Government access to information about specific investments. This contention raises a number of issues and concerns. The data alone would not be sufficient to infer the intent of investors. Also, the information the GAO would have us collect by industry or sector would not identify either the specific firm in which an investment takes place, or allow analysis of such investment. More important, however, is the fact that the data systems authorized by the Congress were not intended to be used to investigate specific foreign investments, or to examine the motivations behind each investment. Such efforts would be impractical and would set a highly undesirable precedent in this country.

Should an individual investment pose a potential threat, we are confident that the U.S. Government's existing data collection and interagency coordination mechanisms would enable us to respond quickly. The principal responsibility for monitoring the significance of foreign investments to the U.S. economy lies with the Committee on Foreign Investment in the United States. This Committee receives information from a variety of sources, including government agencies that collect information on the activities of individual firms for regulatory purposes. Such agencies as the Securities and Exchange Commission and others require foreign-controlled firms to submit periodic reports to them pursuant either to requirements imposed on foreigners per se or on all firms subject to the respective agencies' jurisdiction. The Committee also receives information from various Government agencies that prepare studies and assessments of foreign investment trends on a continuing basis, such as the Office of Foreign Investment in the United States (OFIUS) and the Bureau of Economic Analysis (BEA) at the Commerce Department, the Department of Agriculture in the case of real estate, and my staff at the Treasury. The Committee reviews the latest trends to see if there are any developments which raise policy issues.

In addition, there are existing arrangements by which the governments of all countries, including OPEC, are expected to consult with the U.S. Government when they contemplate major investments in the United States.

In the event that the Committee received information through one of these channels of an investment that might have major adverse implications for U.S. national interests, the Chairman would convene a meeting of the Committee to review it. If its conclusion was that the investment would have such an effect, it would convey this conclusion together with its recommendations for action to the appropriate Cabinet-level group.

In summation, Treasury believes that data now collected by the U.S. Government on foreign investments in the United States are adequate for analytical uses and for public policy formulation and that we have in place procedural arrangements which enable us to respond promptly and effectively to any problems which might arise in this area.

Sincerely,

(Signed) C. Fred Bergsten

C. Fred Bergsten

The Honorable
Jack Brooks
Chairman
Committee on Government
Operations
House of Representatives
Washington, D.C. 20515

Identical letter sent to:

The Honorable Abraham A. Ribicoff
Chairman
Committee on Governmental Affairs
United States Senate
Washington, D.C. 20510

QUESTION: On May 31 and June 7, 1981, The Chicago Tribune Syndicate reported on Kuwaiti equity and other portfolio investments placed through two Citibank accounts. (The columns are attached.)

QUESTION: Do the TIC S Forms filed by Citibank for Kuwait reveal for the period 1974 to December 1978 a net ownership of at least $3.7 billion in equity securities and $3.3 billion in bonds and short-term securities, as indicated by Citibank documents?

ANSWER: TIC Form S addresses transactions in long-term securities only. Broadly, these include securities with no fixed maturity, such as equities, and marketable debt issues with original maturity of more than one year. Holdings of short-term U.S. debt instruments for foreign account are reported as custody liabilities by banks and brokers in the U.S. on monthly TIC Form BL-2. We have reviewed Citibank's TIC forms and have no reason to doubt the accuracy or coverage of that respondent's submissions.

QUESTION: Do the TIC S Forms filed by Citibank for Kuwait reveal for the 12 months ending June 30, 1980 that nearly $33 billion of funds were transferred in and out of accounts and that more than $100 billion of securities transactions were completed during that period?

ANSWER: The issue of Kuwaiti investments in the U.S. concerns not only TIC Form S, but also the B-series forms with respect to custody holdings of short-term securities such as Treasury bills and certificates, commercial paper, certificates of deposit and other money market instruments. Form S collects data on gross purchases and gross sales of long-term securities; however, the B-series forms show outstanding balances in claims and liabilities vis a vis foreigners as of the end of specific calendar periods. They do not, nor need they for balance of payments statistical purposes, collect data on gross movements into and out of accounts for those periods; they show the amount outstanding at the end of the period. Net flows can then be derived, and the latter are used in balance of payments accounts.

QUESTION: Was Citibank in compliance with Treasury reporting requirements? If not, what actions does Treasury intend to take?

ANSWER: We have reviewed the data filed for the period beginning September 1974 and find there is no evidence to suggest that Citibank was not in full compliance with TIC reporting requirements.

QUESTION: Several days after President Carter froze Iranian assets on November 14, 1979, Treasury advised the press that the amount frozen totaled $5 billion and then subsequently $6 billion. On November 19, 1979, this amount was revised to $8 billion and a breakdown on asset categories was furnished. (See 11/20/79 Washington Post.) To obtain more accurate and comprehensive data on Iranian holdings in the United States and in foreign branches of U.S. banks, the Treasury conducted a special census during the first part of 1980. According to former Deputy Assistant Secretary of Treasury Gary Hufbauer, this census revealed that Iran's frozen assets totaled around $13 billion.

a. Please include in your testimony a table showing Treasury's estimates of Iranian assets as of (1) November 19, 1979, and (2) June 30, 1980 (or whenever the special census figures were available), breaking down the assets by investment and deposit categories. (Please utilize the format of Table 2, attached to Treasury's July 2d letter, adding a category for deposits in foreign branches of U.S. banks). Describe those categories where there was a significant discrepancy.

b. It appears that the discrepancies could have been caused in one of two ways: Either there was a large inflow of funds, placed by Iran, between September and November 1979 (for investments in U.S.G. securities and U.S. stocks and bonds and for deposits in banks in the United States), and between June and November 1979 (for deposits in U.S. bank branches abroad, non-bank liabilities (debt), and for direct investment in the United States.) Presumably Iran did not place any significant funds in the frozen accounts and in other investments after the freeze. Or, instead, Treasury's and the Fed's data collection systems did not effectively monitor and pick up substantial Iranian holdings. In view of the Iranian revolution and the substantial decrease in production of oil in the spring of 1979, we question whether $7 to $8 billion (the amount of the discrepancy) flowed into the United States and foreign branches of U.S. banks from June to November 1979. Please furnish evidence, if any exists, of any such flows of funds, indicating the types and general amounts of holdings. Please explain which parts of the Treasury's and the Fed's data collection efforts were not effective and any subsequent steps taken to improve them.

ANSWER: The data available to us on November 19, 1979, were those generated by the Treasury International Capital (TIC) Reporting System, and by the Federal Reserve's FR-2502S reports on loans and deposits of U.S. banks' foreign branches, as updated by a telephone survey of banks and other TIC reporting firms.

As shown on the following table, Treasury's November 19 estimates of the value of Iran's assets subject to U.S. jurisdiction conform closely to the $9.7 billion reported under the census. (The census figure of $13 billion attributed to former Deputy Assistant Secretary Hufbauer is simply inaccurate.) The census data indicate that our November 19, 1979 figure underestimated the amounts held by non-banks by about $910 million, and overestimated the amounts held by the domestic offices of U.S. banks by about $249 million. Both of these differences resulted largely from the treatment of commercial letters of credit for our oil imports from Iran.

The minor differences in the other accounts arise from a variety of normal accounting problems: the price used to evaluate the 1.6 million ounces of gold on deposit with the New York Fed varied between the two estimates; and various liabilities had not flowed through the accounting systems of the reporting companies and government agencies.

Estimates of Iranian Assets Blocked on November 14, 1979
(in millions of dollars)

	Estimated as of 11/19/79	Census as of 10/25/80	Difference
U.S. Government securities	1,235	1,274	-39
Treasury bills and certificates	1,234	n.a.	n.a.
Treasury bonds and notes	1	n.a.	n.a.
Federal agency issues	n.a.	n.a.	n.a.
Corporate bonds Corporate stocks	35	65	-30
Commercial banks liab. in U.S.	1,426	1,177	+249
Demand deposits	n.a.	807	n.a.
Time deposits	n.a.	150	n.a.
Other	n.a.	219	n.a.
Subtotal	2,696	2,516	+180
Nonbanks' liabilities	553	1,463	-910
Direct investment	0	n.a.	n.a.
U.S. Government accounts	435	472	-37
Total investment in U.S.	3,684	4,451	-767
Gold held in U.S.	638	636	+2
Assets blocked abroad			
Banks	4,523	4,546	-23
Nonbanks	n.a.	63	-63
Total	8,845	9,696	-851

QUESTION: On July 18, 1981, the Securities Industry Association (SIA) released a report estimating foreign holdings of U.S. equities. The report criticized the Treasury's foreign portfolio investment survey, released December 1980. The report states:

> The wide divergence between foreign and institutional turnover rates leads to suspicion that the Treasury's figures on current flows are either too high or that the holdings of foreigners are substantially underestimated. We believe that the problem stems from an underestimation of the value of shares held by and for foreigners. The Treasury report notes that the major motivating factors for foreign investment in U.S. stocks are potential capital appreciation and anticipated increases in future income flows. These explanations may be correct, but the rationale is in marked opposition to a 91% foreign turnover rate for the first quarter of 1980 or even a 54% rate for 1979 as estimated by Treasury.
>
> ...These numbers are unrealistic and suggest that Treasury's estimates of the value of securities owned by foreigners are too low.

Based on SIA's adjustments of Treasury's year-end 1978 estimate, Treasury figures would show $55 billion and $75 billion of foreign investment in U.S. securities, for year-end 1979 and 1980 respectively. However, because of the problem noted above, SIA estimates that foreign holdings of equities conservatively ranged in 1979 from $98-$147 billion and in 1980 from $137-$176 billion.

Please respond to the SIA report's conclusions and estimates, particularly focusing on Treasury's assumption that, for its statistics to be correct, foreign investors have a turnover rate approaching or surpassing 100 percent, much higher than that for domestic institutional investors. If defects exist in Treasury's 5-year survey, what actions is Treasury taking to them?

ANSWER: The principal differences between the SIA and Treasury reports and research efforts lie in research objectives and methodology:

1. SIA estimated the level of foreign investment in U.S. equity securities using recorded investment flows and assumed turnover rates.

2. Treasury measured the level of foreign portfolio investment and used this defined measure in conjunction with recorded investment transactions to estimate foreign

portfolio investor turnover rates for purposes of comparison with available domestic investor behavior indicators. Treasury does not assume that foreigners exhibit any particular turnover rate or that any level of turnover in foreigners' portfolios is necessary in order for our statistics to be correct.

Examination of the SIA approach and discussions between Treasury, SIA, Federal Reserve, and Securities and Exchange Commission (SEC) personnel have uncovered differences in computation procedures for turnover rates. When all calculations are performed on a uniform basis and the same investment concepts are addressed, differences between Treasury and SIA estimates of turnover rates and the value of U.S. equity securities held by foreigners virtually disappear.

The SIA methodology for estimating foreigner's holdings of U.S. equities from Form S flow data and assumed turnover rates yields an estimate of the value of total foreign holdings, including direct as well as portfolio investment. Estimates of total foreign holdings of U.S. equities for year-ends 1979 and 1980 based on amounts for both direct and portfolio holdings reported in Treasury's benchmark survey, Treasury International Capital (TIC) Form S reports, and the S&P 500 stock price index are $92.1 billion and $125.8 billion, respectively. These estimates are roughly comparable to the $98 billion for 1979 and $127 billion for 1980 estimated by SIA using turnover rates equal to those observed for the most active U.S. institutional investors.

Employing the SEC's formula to calculate turnover rates and Treasury estimates of the level of foreign portfolio investment in U.S. equity securities, the activity or turnover rates in foreigners' portfolio equity holdings implied by Treasury reports (Form S) on foreign purchases and sales of U.S. equities are calculated as 42.3% in 1979 and 57.5% in 1980. These turnover rates are significantly below the 80-100% range noted in SIA's paper and comparable to the turnover rates for open-end investment companies and some life insurance company portfolios (the most active U.S. institutional investors) as calculated by the SEC.

Recalculation of quarterly turnover rates by Treasury for the period of time covered in our survey report shows that the rates published in the report are too high. Revised estimates are presented in the following table.

One further line of argument advanced in SIA's paper relied upon a comparison of net foreign purchases of U.S. securities and the value of new security issues released on U.S. markets. We do not feel that comparison of these two data series is an appropriate means of evaluating, directly or indirectly, the accuracy or reliability of Treasury's

Selected Portfolio Activity Rates: 1979 and 1980
(In percent)

Type of Investor	1979				1980			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Life Insurance Co. General accounts	15.9	24.1	35.8	35.5	37.5	26.2	29.1	29.0
Life Insurance Co. Separate accounts	39.9	36.6	35.5	41.8	56.8	44.5	52.6	49.1
Open-end Investment Companies	40.3	42.9	50.6	44.2	69.1	49.4	58.8	60.0
Foreign Portfolio Investors	35.6	38.5	46.4	48.4	64.4	43.1	62.8	68.7

Foreign Portfolio Investment Survey
July 22, 1981

benchmark survey results. Such an analysis ignores several significant factors -- the very large amount of U.S. equities outstanding before 1970 and appreciation in the value of these securities between 1969 and 1980. Further, the analysis ignores appreciation in the value of the new security issues themselves.

In executing their comparative analysis, SIA appears to have overlooked several additional facts. SIA's comparison of net foreign U.S. equity purchases and new U.S. equity issues spanned 11 years -- nine years preceding and two years subsequent to Treasury's benchmark survey. The year-end 1978 survey could not possibly have captured activity in 1979 or in 1980, that is, net foreign purchases of $7 billion or new outstanding U.S. equity securities of more than $19 billion.

We are confident that foreigners' holdings of U.S. equity securities acquired prior to December 31, 1978 were reported as required by law.

QUESTION: In 1979 and 1980 the statistical discrepancy in the U.S. balance of payments accounts, reported by the Commerce Department, reached a total of $60 billion, most of which could have been caused by unreported and unidentified capital inflows. The June 1981 "Progress Report of the Interagency Work Group on the Balance of Payments Statistical Discrepancy" discussed some of the possible reasons for this discrepancy. Research staff within the Securities Industry Association believe that Treasury's understating of foreign ownership of equity holdings is partly caused by poor compliance with the TIC system. The "June Progress Report" supports this conclusion for other types of foreign holdings.

Briefly describe the need for the interagency group's examination and the group's findings.

ANSWER: The statistical discrepancy in the 1980 balance of payments accounts amounted to $29.6 billion of unrecorded inflows, or 6.3% of the sum of merchandise exports and imports. The combined total for 1979 and 1980 was $50.8 billion, not $60 billion as earlier estimated. It became evident during 1980 that unrecorded inflows were somewhat larger than usual, and so late last summer we initiated a study of the problem. An interagency work group was formed, and began studies and field investigations which are still continuing.

The overall problem of the balance of payments statistical discrepancy is complex, and will probably never be completely solved. It probably reflects a variety of errors and omissions, both in the current account and in the capital account. It has generally been concluded by those who have studied the problem that rapid unrecorded fluctuations in capital flows, often to and from the Euromarkets, lie at the heart of the problem.

The evidence which the Work Group has been able to bring to light so far suggests that a portion of the unreported inflows of 1980 were associated with Euromarket bank borrowing by domestic corporations. Many loans booked abroad, often in Nassau, the Cayman Islands, and London, are serviced by New York banking offices on behalf of the foreign offices, and the domestic corporation doing the borrowing has sometimes failed to realize that a foreign borrowing was involved. When the borrowing corporation fails to recognize such borrowings as foreign, they are of course unable to report them properly on the Treasury International Capital forms, and the resultant capital inflow is unrecorded.

We are currently working on instructions to TIC respondents to clarify reporting responsibilities and are hopeful that this particular part of the problem may be solved.

The unrecorded flows so far discovered do not suggest that any large amount of long-term foreign investment in the United States has gone unreported. We will continue to examine every possibility, however.

QUESTION: Recommendations 1, 2, and 3 in the "Progress Report" apply to Treasury surveys. Will Treasury fully implement these recommendations? If not, why not? If so, how? What steps is Treasury taking to increase reporting awareness by, and to assure compliance from, firms and banks on the B, C, and S series of TIC forms?

ANSWER: Recommendations 1, 2, and 3 in the "Progress Report" involve actions that would be taken by the Interagency Committee on Balance of Payments Statistics, not by Treasury. The Working Group's first Recommendation to the Interagency Committee dealt with unreported Euromarket bank borrowing by domestic corporations. As noted in the response to the preceding question, we are currently preparing instructions to TIC respondents which we are hopeful will solve this problem.

The Working Group felt that the statistical discrepancy might bear some relationship to the problem of trade credit leads and lags, which might affect reporting either on the Commerce direct investment forms or on Treasury Form CQ-2. The group suggested that it study this issue further. The Interagency Committee felt that this Recommendation should be given relatively low priority, since it was felt that leads and lags work themselves out in time, and that there was little likelihood that the current account had any explanatory power, given the generally satisfactory behavior of trade models.

The last Recommendation suggested that the Working Group consult with investment bankers for the purpose of determining whether all investment banking operations are adequately covered. This was approved by the Interagency Committee, which indicated that attention should also be given to other nonbank financial institutions. This Recommendation will soon be implemented by the Working Group.

QUESTION: The Farm Credit Administration, Government National Mortgage Association, and other Government credit agencies which sell debt securities are unable to report on foreign investment in their securities because their securities are usually sold in bearer bond issues. In the December 1980 Report on Foreign Portfolio Investment in the U.S., the Treasury noted (page 30) that the disproportionately small debt amounts shown in the survey "was due, in part" to the inability of the survey to obtain complete information on foreign-held bearer bond issues." Discuss all possible options to overcome this inability to monitor foreign ownership of such debt securities and the benefits and costs of each option.

ANSWER: It is possible to estimate, but not monitor, the extent and geographic distribution of U.S. bearer-type debt securities held abroad by foreign residents. In particular, corporate debt securities issued abroad in bearer form are not readily susceptible to measurement in a benchmark survey. However, each estimating procedure we have been able to devise would rely heavily on assumptions which may not be valid, would impose additional reporting burdens on the private sector, and would be costly to the government.

Page 30 of Treasury's 1978 benchmark survey report noted the inability of the survey to obtain complete information on foreign-held bearer bond securities issued by private sector corporations chartered in the United States. Prior to 1974, private corporations (unlike U.S. Government agencies) issued some marketable, long-term bearer securities across national boundaries that may continue to be outstanding.

However, the volume of new debt securities issued today in foreign markets by corporations chartered in the United States is negligible. Therefore, there is reason to believe that the problem of measuring foreign portfolio holdings of U.S. corporate bearer bonds will decline as outstanding issues mature.

The ability of a benchmark survey to measure total foreign portfolio holdings of U.S. Government and Government-sponsored agency securities will also improve over time: the outstanding issues will mature, and fewer bearer securities are issued today than were issued in the past. Government-sponsored agency securities of more than one year maturity are issued now <u>only</u> in book-entry form. U.S. public debt securities of more than one year maturity may still be purchased in bearer form; however, 90% of new long-term securities are issued in book-entry form that would be reported.

Also, while foreigners can purchase new public debt securities in bearer form and transport them abroad, they are unlikely to do so. Redemption of either interest coupons or the securities themselves would require returning the instruments to the United States as all redemption agents for the instruments are located here. The securities would likely remain in the United States with U.S. custodians and be reported in a benchmark survey.

The Government National Mortgage Association does not issue securities but guarantees pass-through certificates which are backed by pools of FHA-insured or VA-guaranteed mortgages. The certificates are in physical form and are registered. Chemical Bank of New York acts as the central registrar for GNMAs and provides the issuers with the names and addresses of the registered owners.

Expenditure of resources to develop estimates of U.S. bearer securities held abroad would be less productive than our continuing efforts to monitor current international portfolio investment developments through the ongoing TIC reporting system. Treasury's monthly Form S reporting encompasses foreigners' purchases and sales of U.S. bearer-type securities, and we have reason to believe foreigners' transactions in bearer-type U.S. securities are routinely included in those reports. The change between benchmark years in the level of U.S. Government agency and corporate debt securities was in line with the level implied by Form S reports over the four years between surveys.

<u>QUESTION</u>: In response to the Committee's August 1980 report's recommendation that OPEC country investment information be made available to the public, the Congress, and other agencies, Treasury stated that OPEC country investment figures had been classified as national security information under Executive Order No. 12065, June 28, 1978.

1. Which level of classification has been given to the OPEC country investment figures, including those showing asset and investment breakdowns?

2. Set forth specifically the date of and the circumstances surrounding the classification of this data. Has the classification designation been changed at all since the original classification? If so, when and for what reason?

3. Who at Treasury originally classified this information and who continues to classify it?

4. Please indicate how this information met classification requirements set forth in the Executive Order and specify the damage to the national security which could entail from release of this information.

ANSWER: Regarding (1), data in respect of the portfolio investments of Middle East and African oil-exporting countries in the United States are classified "CONFIDENTIAL".

Regarding (2), they were classified when Treasury first obtained the full range of bank and portfolio investment data for these countries as of September 1974. There has been no change in the classification designation since the original classification.

Regarding (3), classification of these data is currently done under the authority of C. Dirck Keyser, who has been delegated authority to classify documents "CONFIDENTIAL". Documents containing these data were originally classified "CONFIDENTIAL" by Chester Callander, Mr. Keyser's predecessor as Director, Office of International Financial Reports.

Regarding (4), this information is classified "CONFIDENTIAL" because its unauthorized disclosure could reasonably be expected to cause identifiable damage to the national security. "National security" is defined to include the foreign relations of the United States, which clearly would be impaired by disclosure against the wishes of the countries in question.

QUESTION: One of the primary reasons for the creation of the Interagency Committee on Foreign Investment in the United States (CFIUS) was to monitor OPEC government investments. (See 20th Report of the Committee on Government Operations, 96th Congress, p. 166.) Executive Order 11858, May 7, 1975, conferred on CFIUS the primary continuing responsibility for monitoring the impact of foreign investment and providing guidance to foreign governments for advance consultations on prospective major foreign government investments.

To carry this out, former Assistant Secretary Parsky visited with the major OPEC governments to request that they consult with Treasury or CFIUS prior to major investments. As noted in the subcommittee's hearing transcript on CFIUS (Part 3, p. 345), Kuwait did not agree to prior consultations. A summary of a memo furnished to the subcommittee by another government agency (Doc. 28), (attached), confirms this government's refusal to agree to prior consultations. Please respond to the following:

1. Has the Kuwaiti government voluntarily consulted with the Treasury or with CFIUS about any investments in the United States during the last two years? If not, has the U.S. Government attempted to obtain and has it received assurances from Kuwait regarding prior consultations on investment? Has Kuwait consulted CFIUS on specific investments, including several attempted and actual investments in the energy/petroleum sector? Please describe those consultations or attempts.

2. Has CFIUS in any way examined within the last two years any OPEC government investments? If so, indicate (a) the proposed investment, (b) the country involved, (c) whether the foreign government initiated consultations and when, (d) the extent of CFIUS' deliberations (meetings, phone calls, conversations, etc.), (e) the concerns expressed, (f) the decisions reached and/or actions taken, and (g) the eventual disposition.

ANSWER: The Government of Kuwait has consulted with the CFIUS on three investments. In each case, the consultations were initiated by the Committee. In the course of those consultations, Assistant Secretary Leland made clear to the Kuwaiti Ambassador that we request advance consultation when the government is planning a major investment in the United States.

One of the investments discussed, in Getty Oil, was never completed, and the CFIUS did not conduct a formal review, although it was prepared to do so if the investment had proceeded. The CFIUS has reviewed the Kuwait Petroleum Corporation-Pacific Resources Inc. joint venture proposal. The Committee, after a rather lengthy examination of the possible impact of this investment on U.S. national interests, determined that the investment did not have negative implications for the United States.

The CFIUS is currently reviewing a third proposed Kuwait investment, a joint venture between KPC and AZL, an Arizona minerals developments firm. No other OPEC investments have been reviewed. The CFIUS does of course monitor foreign investments in the United States including OPEC's. Investments are discussed at CFIUS and CFIUS staff meetings, and the Office of International Investment in Commerce prepares weekly reports on major investments in the United States.

QUESTION: Recent articles in the Wall Street Journal (3/30/81 and 5/22/81) indicate that (a) Saudi investible surpluses probably total around $120 billion or a little less, (b) with oil production at 10 M/B/Day, Saudi annual revenues are running around $120 billion, and (c) Saudi expenditures for the fiscal year just ending were around $96 billion. One of the authors of the Journal articles believes that the declining demand for oil and the stabilizing of prices--assuming no unforeseen political events--will result in a reduction of Saudi Arabia's "cushion" of accumulated official foreign assets (both reserves and investments) over a period of two to four years.

If this scenario proves accurate, and if the types of Saudi purchases of goods and services remain generally the same with increases as to amounts, what would be the effect of such a draw-down of approximately $120 billion (a) on the stability of the U.S. and international banking systems, (b) the Federal deficit, (c) the value of the dollar, and (d) world's and the U.S.' economy in general? Have any studies been conducted on such an eventuality and with what conclusions?

ANSWER: The likelihood of complete or substantial elimination of Saudi Arabia's foreign exchange reserves over the next two to four years is extremely remote. However, even with the assumption in the question of a decline of $30 billion a year the international financial system would not be impaired. Similarly, there is no *a priori* reason to assume that such an event would have any particular impact on the Federal deficit or the value of the dollar.

It is important to emphasize that a change in the level of Saudi Arabia's foreign exchange reserves does not in itself change the amount of dollars or any other currency in circulation or the assets in the hands of the monetary authorities of the Western countries. A reduction in Saudi oil revenues coupled with a continued high level of Saudi expenditures abroad would, *ceteris paribus*, result in a change in the ownership of assets now held by Saudi Arabia to the benefit of those countries, firms, and individuals providing goods and services to Saudi Arabia.

QUESTION: In 1978, Saudi Arabia apparently drew down its assets in the United States, when it reportedly sold $2.4 billion more of U.S. Government securities than it purchased. Were there any undesirable or negative effects on the U.S. economy, U.S. financial markets, the dollar's value, or on U.S. Treasury debt financing from this smaller draw-down? For Government securities, what did Treasury do to stem liquidations and minimize disruptions of its sales and interests?

ANSWER: Treasury's net market borrowing for calendar year 1978 was approximately $33 billion. In addition, that same year the Treasury raised $23 billion in nonmarketable issues, including nonmarketable foreign-currency denominated securities issued abroad; and Treasury refunded approximately $231 billion of maturing marketable securities. In the highly liquid market for Treasury securities, a net sale over a year of $2.4 billion of Treasury securities would be too small to be disruptive or to require any special actions by the Treasury.

QUESTION: Which types of OPEC country investments would be the most disruptive and the least disruptive to U.S. financial markets, to the U.S. economy, and to U.S. national interests?

In answering, please address the following points. Some observers believe that OPEC country equity investments and private debt placements are more in the interests of the United States and the international financial system, because they would "tie down" funds which could destabilize the system if they remained in liquid assets. Others believe that bank deposits and Government securities -- though liquid -- are preferable because (a) that type of investment is easier to observe, and (b) while it may confer on these OPEC countries some influence with the banks involved and with Treasury, it confers less control than equity investments. Still others favor OPEC country investments in long term bank deposits and Government securities. What is Treasury's view?

ANSWER: The question assumes that OPEC or other foreign investments in the U.S. would have a disruptive effect on markets and that the only issue is the extent of the negative impact. As noted in my statement, it is our view that foreign investments in response to market forces are beneficial, not injurious to the United States.

The impact of any particular investment activity on the functioning of U.S. markets will be the same whether such activity is undertaken by a resident or non-resident. Whether an investment has a disruptive effect will depend, among other things, on the circumstances surrounding the investment in question, its characteristics, and a value judgment as to what constitutes market disruption. Consequently, it is not possible to come to a generalized conclusion about hypothetical actions that could disrupt U.S. markets in one degree or another.

The question also assumes that foreign investors will invest in the United States with the intent to disrupt U.S. markets or do harm to the U.S. economy. Such action would be detrimental to their own economic interests. Investors with large portfolio holdings are attracted to U.S. capital markets because of their size and the fact that large holdings can be liquidated with little overall negative effect on their other dollar holdings.

QUESTION:

1. We require the following information on the Saudi Arabian Procurement Staff, which is part of the Office of Procurement, under the Assistant Secretary for Administration:

   a. When was this staff created and what is its purpose?

   b. How many staff members are there and what are the responsibilities and duties for each staff member?

   c. Are the salaries for these persons and other office expenses paid by the Saudi Arabian Government or the U.S. Government? What have total expenses been in the last three fiscal years? What are the specific sources of funds?

   d. If paid for by the Saudi Arabian Government, are there any others within the Treasury Department whose salaries or expenses are paid, directly or indirectly, by a foreign government?

2. We require the very same information for the Saudi Arabian office, headed by a Deputy to the Assistant Secretary for Saudi Affairs under the Assistant Secretary for International Affairs. (Please answer above questions a. through e. for this office.)

3. Please furnish a full accounting of all Saudi Arabian and other OPEC country funds on deposit with the U.S. Treasury. Specify the reason for and uses of any such deposits.

1. Question A: Establishment Date and Purpose of
Saudi Arabian Procurement Support Staff
Office of Procurement
Assistant Secretary for Administration

The Treasury Office of Procurement's Saudi Arabian Procurement Support Staff was established in May 1976. It is responsible for the development, preparation, award, and administration of contracts and procurement obligations in support of the Department's responsiblilities under the U.S. - Saudi Arabian Joint Commission's Technical Cooperation Agreement. The Staff obligates funds from the Saudi Deposit Account for these procurements. It also performs liaison work with the administrative staffs of Treasury's Office of the U.S. Representation (USREP) in Riyadh, Saudi Arabia, and with its Office of Saudi Arabian Affairs (ISW) in Washington, D.C., on all matters pertaining to procurement for the Saudi Araian Government. The chief of the Saudi Arabian Procurement Support Staff reports to the Director of the Office of Procurement

Question B: Size and Responsibilities of Staff within the
Saudi Arabian Procurement Support Staff

Three full-time and one part-time personnel are presently assigned to the Saudi Arabian Procurement Support Staff. All these positions are funded by the Saudi Arabian Government. The positions are as follows:

Position	Responsibilities	Funding Source
Contract Specialist (full-time position)	Serves as Chief of the Saudi Arabian Procurement Support Staff and principal contract specialist, with full delegated contracting officer authority without dollar limitation, for all contracting/procurement matters connected with the Saudi Arabian Deposit Account.	SAG
Contract Specialist (full-time position)	Serves as principal assistant to the Chief and as contracting officer with authority limited to $10,000.	SAG

Question B: Size and Responsibilities of Staff within the Saudi Arabian Procurement Support Staff (Continued)

Position	Responsibilities	Funding Source
Clerk-Typist (full-time position)	Performs a variety of clerical, typing and related administrative support duties for the Chief and the staff.	SAG
Student-Research Assistant (part-time position)	Assists Contracting Officers in preparation of contracts; compiles information, prepares preliminary documents, and reviews documents for completeness	SAG

Question C: Expenditures and Funding of the Saudi Arabian Procurement Support Staff

As noted above, all positions within the Saudi Arabian Procurement Support Staff are funded by the Saudi Government by funds drawn from the Saudi Arabian Deposit Account. Total expenditures for this Staff during the past three fiscal years are as follows:

FY 81 (Estimate)	FY 80	FY 79
$95,000	$50,000	$44,900

Total expenses for the three year period = $189,900

Question D: Other Saudi-funded Offices within the Department of the Treasury

See Question 2 below.

2. Question A: Establishment Date and Purpose of Deputate for Saudi Arabian Affairs

The Office of the Deputy for Saudi Arabian Affairs was created pursuant to Treasury Department Order No. 232, dated June 23, 1974, to provide the institutional framework required to carry out U.S. Government obligations deriving from a Joint Communique issued on June 8, 1974. That communique stated the intention of the U.S. and Saudi Governments:

> To establish a Joint Commission on Economic Cooperation. This Commission will be headed by the Secretary of the Treasury for the United States and by the Minister of State for Finance and National Economy for Saudi Arabia. Its purpose will be to promote programs of industrialization, trade, manpower training, agriculture, and science and technology.

Implementation guidelines for the Joint Communique were formally agreed upon by the two Governments in a Technical Cooperation Agreement (TCA) signed February 13, 1975. This agreement, which has a life span of five years, was extended on November 25, 1979 until November 25, 1985. The TCA indicates Saudi Arabian Government agreement to defray all direct and indirect costs incurred by the U.S. Government in carrying out Commission activities and makes arrangements for the establishment of a dollar deposit account by Department of the Treasury into which all Commission funding will be deposited by the Saudi Government on an advance of funds basis.

Four Offices currently exist under the authority of the Deputy for Saudi Arabian Affairs:

(1) the immediate Office of the Deputy;
(2) the Office of Saudi Arabian Affairs located in Washington, D.C.
(3) the Office of the U.S. Representation to the Joint Commission located in Riyadh, Saudi Arabia.
(4) the Office of the Treasury Attache located in in Jidda, Saudi Arabia.

The primary purpose of the Deputate and of the Office of Saudi Arabian Affairs is the management of the U.S.-Saudi Arabian Joint Economic Commission program. These two offices also provide economic briefings and other information concerning Saudi Arabia to the Assistant Secretary for International Affairs and other senior Treasury officials.

Question A: Establishment Date and Purpose of Deputate for Saudi Arabian Affairs (Continued)

The purpose of the Office of the U.S. Representation is the management of the Joint Commission program with special responsiblity for providing logistical and administrative support to U.S. Government personnel stationed in Saudi Arabia in connection with project activities.

The purpose of the Office of the Treasury Attache is to provide briefing and analysis to U.S. Embassy officials in Saudi Arabia and to senior Treasury officials on matters of economic and financial interest in the USG - SAG relation.

Copies of the Technical Cooperation Agreement and a Joint Commission Fact Sheet describing Joint Commission activities are included for reference purposes.

Question B: Size and Responsibilities of Staff within the Deputate for Saudi Arabian Affairs

Four Offices exist within the Deputate for Saudi Arabian Affairs:

(1) The immediate Office of the Deputy (2 persons);
(2) The Office of Saudi Arabian Affairs located in Washington, D.C. (24 persons);
(3) The U.S. Representation Office to the Joint Commission located in Riyadh, Saudi Arabia (21 persons).
(4) The Office of the Treasury Attache located in Jidda, Saudi Arabia (2 persons);

Forty-nine total Treasury personnel thus exist within the Deputate for Saudi Arabian Affairs. A break-down of these personnel, indicating duties performed and indicating the source of funding (SAG = Saudi Arabian Government funded and IA = International Affairs, U.S. Government funded) follows.

(1) The Immediate Office of the Deputy

Position	Responsibilities	Funding Source
Deputy for Saudi Arabian Affairs	Manages all activities of Deputate	IA
Saudi Arabian Program Specialist	Provides program analysis and support to Deputy	IA

Question B: Size and Responsibilities of Staff within the Deputate for Saudi Arabian Affairs (Continued, page 2)

(2) The Office of Saudi Arabian Affairs (Continued)

Position	Responsibilities	Funding Source
Director	Manages all activities of Office	IA
Deputy Director	Assists Director and coordinates projects being implemented by agencies other than Treasury	IA
Financial Manager	Manages Saudi Arabian Deposit Account	IA
Director's Secretary	Provides secretarial and clerical support to Director	IA
Deputy Director's Secretary	Provides secretarial and clerical support to Deputy Director	IA
Economist (two persons)	Provide briefings and analysis to senior Treasury officials on matters of key economic and financial interest in the USG - SAG relation	IA
Foreign Affairs Officer	Coordinates projects being implemented by Treasury	SAG
Foreign Affairs Officer	Supervises Treasury direct projects in areas such as Electrical Power Installation	SAG
Foreign Affairs Officer	Supervises Treasury direct projects in areas such as University assistance	SAG

Question B: Size and Responsibilities of Staff within the Deputate for Saudi Arabian Affairs (Continued, page 3)

(2) The Office of Saudi Arabian Affairs (Continued)

Position	Responsibilities	Funding Source
Program Analyst	Supervises National Center for Financial and Economic Information and other direct Treasury projects	SAG
Foreign Affairs Officer	Oversees a number of projects being carried out by agencies such as Departments of Labor, Transportation, and Commerce	SAG
Foreign Affairs Officer	Oversees a number of projects being carried out by agencies such as NSF, Farm Credit Administration, and Agriculture	SAG
Program Analyst	Oversees development of computerized accounting system to manage disbursements from Deposit Account	SAG
Program Analyst	Controls disbursements from Deposit Account	SAG
Foreign Affairs Officer	Oversees U.S. training activities for Saudi employees working with the Commission	SAG
Program Analyst	Coordinates operations and administrative support provided by Treasury to field personnel	SAG
Saudi Arabian Support Technician	Oversees recruitment and processing of new personnel	SAG

Question B: Size and Responsibilities of Staff within the Deputate for Saudi Arabian Affairs (Continued, page 4)

Program Analyst	Oversees Treasury administrative contracts in areas such as recruitment, freight forwarding, and visa expedition	SAG
Secretaries (five persons)	Provide secretarial and clerical support to professionals within the Office	SAG

(3) Office of the U.S. Representation to the Joint Commission

Position	Responsibilities	Funding Source
Director	Manages all activities of Office	IA
Deputy Director	Assists Director and coordinates project oversight	IA
Comptroller	Manages local disbursements and assists in project budget preparation	IA
Director's Secretary	Provides secretarial and clerical support to Director	IA
Deputy Director (Management Operations)	Coordinates administrative and logistical support provided to Joint Commission community	SAG
Senior General Services Officer	Coordinates provision of housing, vehicles, and related support to Joint Commission community	SAG
General Services Officer	Oversees contractor-provided motorpool and transportation services	SAG
General Services Officer	Oversees leasing and contractor-maintenance of housing	SAG

Question B: Size and Responsibilities of Staff within the Deputate for Saudi Arabian Affairs (Continued, page 5)

(3) Office of the U.S. Representation (Continued)

Position	Responsibilities	Funding Source
General Services Officer	Oversees warehousing and equipment and furniture rehabilitation and distribution	SAG
Program Development Officer	Monitors and coordinates project activity in fields such as agriculture, statistical assistance, and electrical equipment installation	SAG
Program Development Officer	Monitors and coordinates project activity in fields such as science and technology, desalination research, and solar energy.	SAG
Program Development Officer	Monitors and coordinates project activity in fields such as consumer protection, financial and economic information, and University assistance	SAG
Program Development Officer	Monitors and coordinates project activity in fields such as highway transportation, audit administration and training, and centralized procurement	SAG
Accountant	Assists Comptroller in controlling and processing disbursements	SAG
Program Analyst	Coordinates on-site administrative and personnel support	SAG

Question B: Size and Responsibilities of Staff within the Deputate for Saudi Arabian Affairs (Continued, page 6)

(3) Office of the U.S. Representation (Continued)

Position	Responsibilities	Funding Source
Contracting Officer	Designated Contracting Officer authorized to contract and procure goods and services	SAG
Assistant Contracting Officer	Assists Contracting Officer and specializes in local procurement	SAG
Assistant Contracting Officer	Assists Contracting Officer and specializes in review and analysis of existing contracts	SAG
Communicatons Management Specialist	Monitors and oversees communications system including data terminals, dedicated satellite telephone link, and telex facilities	SAG
Chief, Translation Services	Coordinates Arabic-English translation work for Joint Commission community	SAG
Training Officer	Coordinates on-the-job and other training for Saudi employees working with Commission projects	SAG

(4) Office of the Treasury Attache

Position	Responsibilities	Funding Source
Economist (Attache)	Provides briefing and analysis to U.S. Embassy officials in Saudi Arabia and to senior Treasury officials on matters of key economic and financial interest in the USG - SAG relation	IA
Secretary	Provides secretarial and clerical support to the Attache	IA

Question C: Expenditures and Funding of the Deputate for Saudi Arabian Affairs

As noted above, fifteen IA-funded positions and thirty-four SAG-funded positions exist within the Deputate for Saudi Arabian Affairs. IA funds are drawn from the budget of the Assistant Secretary for International Affairs. SAG funds are drawn from the Saudi Arabian Deposit Fund. Total expenditures by this Deputate during the last three fiscal years are as follows:

IA FUNDING*

Location	FY 81 (Estimate)	FY 80	FY 79
Washington	$444,800	$411,100	$470,100
Riyadh	232,400	218,300	225.300
Jidda	90,800	83,600	75,500
Subtotals	$768,000	$713,000	$770,900

Total IA funding for the three year period = $2,251,900

* In FY 79 Funding came from ESF. As of FY 80 it changed to IA.

SAG FUNDING (SALARIES, ALLOWANCES, AND BENEFITS)

Location	FY 81 (Estimate)	FY 80	FY 79
Washington	$ 603,000	$ 378,700	$ 279,100
Riyadh	1,158,000	620,300	339,600
Subtotals	$1,761,000	$ 999,000	$ 618,700

Total SAG funding for the three year period = $3,378,700

Total combined SAG and IA funding for the three-year period = $5,630,600.

Question D: Identification of other Saudi-funded Positions Within the Department of the Treasury

In addition to the Saudi-funded positions noted above in the Office of Procurement and in the Deputate for Saudi Arabian Affairs, four Saudi-funded positions currently exist in the Saudi Support Staff of the Department of the Treasury's Office of Telecommunications.

This Support Staff was established in January of 1980 for the purpose of providing technical assistance and guidance to Treasury in the development and operation of a sophisticated communications system linking Treasury's Office of the U.S. Representation and Treasury and other Joint Commission project teams in Saudi Arabia with points in the United States. The system currently includes a dedicated satellite phone link permitting data and voice communications, telex and other message traffic, a digital facsimile machine permitting transfer of visual images, and a remote searching from U.S. data bases via computer terminal.

All positions on the Saudi Support Staff are SAG-funded. These positions are as follows:

Position	Responsibilities	Funding Source
Chief, Saudi Arabian Telecommunications Support Staff	Serves as Chief of the Support Staff, managing all activities and coordinating work of USREP Communications Management Specialist	SAG
Supervisory Telecommunications Specialist	Assists Chief of the Support Staff and works with Joint Commission agencies in Washington and in Riyadh to develop and expand the communications system	SAG
Telecommunications Specialist	Oversees development of system applications in the areas of electronic mail, computer programming, and word processing	SAG
Telecommunications Specialist	Maintains communications equipment and coordinates new equipment installation, testing, and usage	SAG

Expenses of the Saudi Support Staff since its inception in 1980 are as follows:

FY 81 (Estimate)	FY 80	FY 79
$132,500	$70,500	not in existence

Total funding for the period = $203,000

Question 3: Full Accounting of Saudi Arabian and other OPEC Country funds on deposit with U.S. Treasury

Below is a current accounting of Saudi Arabian funds on deposit in the Saudi Arabian deposit account in the U.S. Department of Treasury as of May 31, 1981.

United States Department of the Treasury Status of Account for Saudi Arabian Technical Cooperation Agreement (Account Symbol 20X6423)

Cumulative through May 31, 1981

Total deposits by Saudi Arabia	$ 525,855,192.76*
Deposits by U.S. Government for Solar Energy Project	32,750,000.00
Interest and profit on securities	42,356,866.90**
Total	600,962,059.66
Less: Payments	433,865,406.50
Total Assets	167,096,653.16
Investment Holdings (Face Value)	$ 157,760,000.00**
Less: Discount on investments	-11,161,840.37**
USG Undisbursed Funds	10,537,385.00
SAG Undisbursed Funds	9,961,108.53
Total Assets	$ 167,096,653.16

* The reason and uses of these funds are to defray costs incurred by the U.S. Government in carrying out Joint Economic Commission activities.

** Pertains to SAG deposits only

No other OPEC countries maintain any significant amount (i.e., over $10 million) of funds in deposit accounts at the U.S. Treasury.

SAUDI ARABIA

Technical Cooperation

Agreement signed at Riyadh February 13, 1975;
Entered into force May 12, 1975.

2

TECHNICAL COOPERATION AGREEMENT

BETWEEN THE

GOVERNMENT OF THE ROYAL KINGDOM OF SAUDI ARABIA

AND THE

GOVERNMENT OF THE UNITED STATES OF AMERICA

Whereas, the Government of Saudi Arabia and the Government of the United States have expressed their readiness to expand cooperation in the fields of economics, technology, and industry, and whereas, the Government of Saudi Arabia and the Government of the United States wish to regularize procedures for such cooperation; and whereas, the Second Deputy President of the Council of Ministers and Minister of the Interior of Saudi Arabia and the Secretary of State of the United States have agreed to the establishment of a Joint Commission on Economic Cooperation to be headed by the Secretary of the Treasury of the United States and by the Minister of State for Finance and National Economy for Saudi Arabia; and whereas, this Agreement will provide a mechanism to facilitate the furnishing of technical and advisory services to implement the goals of the Joint Commission, and other mutual objectives of the two Governments.

It is hereby agreed that:

1. The Government of the United States will make available to the Government of Saudi Arabia, for the purpose of assisting the Government of Saudi Arabia in the development of its economic and human resources, advisors for the provision of such professional and technical advisory services as may be mutually agreed between the Government of Saudi Arabia and the Government of the United States. Advisors may be furnished from within or from outside the Government of the United States.

Services provided under this article may include training in the United States or visits designed to assist in the acquisition of specialized technical or professional knowledge, for citizens selected by the Government of Saudi Arabia.

2. The two governments, in consultation, shall adopt mutually agreeable organizational arrangements to facilitate cooperative implementation of this Agreement, and each side shall designate appropriate administrative entities to deal with each other in fulfilling the provisions of this Agreement.

3. Accord may be reached between the two governments in the context of this agreement that the United States Government, if so requested by the Government of Saudi Arabia, will undertake the preparation of technical or economic studies of specific development projects and provide technical and professional services for the implementation of these projects in accordance with mutually agreed cost estimates and the provisions of this agreement. Should such accord be reached, the Government of Saudi Arabia shall defray any and all costs to the Government of the United States arising from such activities including indirect costs, planning costs, and the costs of project termination, and exempt the United States Government from any taxes on ownership or use of property and any customs duties, import and export taxes or any other taxes or similar charges in Saudi Arabia.

4. The Government of the United States may assign such personnel to Saudi Arabia as may be necessary to provide adequate administrative and staff support to carry out the purposes of this Agreement. The Government of Saudi Arabia will defray all costs of providing such administrative and staff support.

5. (a) The Government of Saudi Arabia will establish a dollar trust account in the United States Treasury and provide in such account, in advance, the full amount of funds necessary to cover the cost described in Article 3, or any increased cost under any mutually agreed increased cost estimate. The Government of the United States may draw on this account to defray the costs as incurred by the Government of the United States in providing such services.

(b) Any funds required by the Government of the United States to pay costs to be defrayed by the Government of Saudi Arabia under Article 4, including any payments to the Government of the United States employees, shall be deposited by the Government of Saudi Arabia in the trust account in such amounts and at such times as are mutually agreed and the Government of the United States may draw on the account for this purpose in the amount so agreed.

(c) The Government of the United States shall provide to the Government of Saudi Arabia a statement at the end of each six months period during which the trust account is operative of funds in the account at the beginning of such period, disbursements from the account during such period, and the balance in the account at the end of such period.

(d) In no event shall the Government of the United States be obligated to provide services under this Agreement for which funds are not available in the trust account.

6. If, upon termination of this Agreement, there are funds remaining in the trust account after all costs have been defrayed and all liabilities satisfied, such funds shall be refunded to the Government of Saudi Arabia.

7. American employees of the Government of the United States who are: (1) assigned to perform services under this Agreement, or (2) assigned to provide support for such personnel will be considered attached to the Embassy of the United States of America in the Kingdom of Saudi Arabia and they and their dependents in the Kingdom of Saudi Arabia shall be entitled to the privileges and immunities accorded to personnel of the Embassy of comparable rank and category. Such privileges shall not extend to employees of establishments or corporations under contract to the Government of the United States or the Government of Saudi Arabia in accord with this Agreement.

8. When requested by either government, representatives of both governments will meet to review progress toward meeting the purpose of this Agreement, and to negotiate solutions to any outstanding problems.

9. (a) The Government of Saudi Arabia agrees that no claim will be brought by the Government of Saudi Arabia against the Government of the United States or its employees that may arise as a result of the technical services furnished under this Agreement, and further agrees to hold the Government of the United States harmless against any and all claims that may arise as a result of the technical services furnished under this Agreement.

(b) The Government of Saudi Arabia reserves the right to bring any claims it has against any private persons, individual or corporate, performing services under this Agreement, and the Government of the United States should exercise reasonable efforts including assigning rights of the Government of the United States to facilitate the foregoing.

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10: After being officially promulgated in Saudi Arabia and after the Government of Saudi Arabia has provided written notice thereof to the United States Government, this Agreement shall remain in effect for five years from the date of signature, subject to revision or extension, as mutually agreed, and may be terminated at any time by either government by one hundred and eighty days advance notice in writing.

In witness whereof, the parties hereto have executed at Riyadh, Saudi Arabia, this agreement on technical cooperation on the thirteenth day of February, 1975, which is the second of Safar 1395 Hegira.

For the Government of the United States of America	For the Government of the Royal Kingdom of Saudi Arabia
James E. Akins Ambassador of the United States of America	Muhammed Aba al Khayl Minister of State for Finance and National Economy

August, 1981

FACT SHEET

U.S.-SAUDI ARABIAN JOINT COMMISSION

ON ECONOMIC COOPERATION

The U.S.-Saudi Arabian Joint Commission, the first of its kind between the United States and a Middle Eastern country, was formally established on June 8, 1974, by a Joint Communique issued by U.S. Secretary of State Kissinger and Prince Fahd, now Saudi Arabia's Crown Prince and the First Vice President of its Council of Ministers.

The Joint Communique stated the mutual desire of the United States and Saudi Arabia to:

> ...promote programs of cooperation between the two countries in the field of industrialization, trade, manpower training, agriculture and science and technology...

With these goals in mind, the Joint Commission was established to provide a formal government-to-government mechanism by which the expertise present in the various parts of the United States and Saudi Arabian Governments and their respective private sectors could be pooled and brought to bear on the development needs of the Saudi economy.

The Joint Commission is chaired by the U.S. Secretary of the Treasury Donald Regan and Saudi Arabian Minister of Finance and National Economy Muhammad Abalkhail. It is coordinated on the U.S. side by Assistant Secretary of the Treasury Marc Leland and on the Saudi side by Deputy Managing Director of the Saudi Fund for Development Khalid Al-Masaud.

In order to support and coordinate Joint Commission work on the U.S. side, the Department of the Treasury established the Office of the Deputy for Saudi Arabian Affairs and two offices subordinate to him: the Office of Saudi Arabian Affairs in Washington, and the Office of the U.S. Representation to the Joint Commission in Riyadh or USREP/JECOR. Technical assistance provided by these offices is carried out on a reimbursable basis in accordance with a Technical Cooperation Agreement signed February 13, 1975, between the U.S. and Saudi Arabian Governments. This agreement was extended on November 25, 1979 for the five-year period 1980-1985.

Expenses are defrayed by drawing against a multi-million dollar trust fund held by Treasury which was established by the SAG pursuant to this agreement.

SUMMARY OF PROJECTS

Project title	Date signed (Term)	Project Objectives	U.S. and Saudi action agencies	U.S. professional staff in Saudi Arabia (May 1981)
Statistics and Data Processing (STADAP)	9-23-75 extended to August 1985)	Upgrade statistics and National Computer Center operations	Dept. of Commerce (Census); Min. of Finance and National Economy	28
Agriculture and Water Development (AGWAT)	11-23-75 (Indef)	Advise regarding agricultural development, water resources and research	Depts. of Agriculture and Interior; Min. Agriculture and Water	31
National Park Development (KINAPARK)	2-16-77 (subproject)	Design and construct national park	Dept. of Interior; Min. of Agriculture and Water	3
Electrical Services (POWERGRID)	2-29-76 (Indef)	Planning and technical services in electricity	Dept. of Treasury and Chas. T. Main, Int'l Inc.; Min. of Industry and Electricity	3
Support for Science and Technology (SANCST)	2-29-76 (Indef)	Institutional development of Saudi Arabian National Center for Science and Technology (SANCST)	National Science Foundation; SANCST	0
Manpower Training and Development (VOTRAKON)	6-12-76 (9 years)	Develop vocational training program; advise on training center construction	Dept. of Labor and General Services Admin.; Min. Labor and Social Affairs	41
National Center for Financial and Economic Information (NCFEI)	5-3-77 (Indef)	Financial information and analysis	Dept. of Treasury; Min. of Finance and National Economy	25
Desalination Research and Training (HYDROS)	5-3-77 (Indef)	Establish research and training center	Dept. of Interior; Saline Water Conversion Corp.	3
Consumer Protection (CONPROT)	5-3-77 (5 years)	Develop food quality control system	Dept. of Treasury and Midwest Research Institute; Min. of Commerce	21
Highway Administration (HIGHWAY)	8-26-77 (6 years)	Provide management, administration, and technical services	Dept. of Transportation (FHWA); Min. of Communications	11
Solar Energy Research and Development (SOLERAS)	10-30-77 (5 years)	Applied research and development in solar energy (joint funding)	Dept. of Energy and Solar Energy Research Institute; (SANCST)	2

SUMMARY OF PROJECTS
-2-

Project title	Date signed (Term)	Project Objectives	U.S. and Saudi action agencies	U.S. professional staff in Saudi Arabia (May 1981)
Audit Services (AUDIT)	5-15-78 (Indef)	Provide management assistance and audit services	Dept. of Treasury; General Audit Bureau	7
Customs Administration and Training (CUSTOMAT)	6-22-78 (Indef)	Advise on Customs operations and provide training	Dept. of Treasury (Customs); Min. of Finance and National Economy	4
Supply Management Development (CENPRO)	7-13-78 (Indef)	Develop central supply management and procurement system	General Services Administration; Min. of Finance and National Economy	7
Nasseriah Power Station Equipment and Services (LIVESWITCH)	11-9-78 (letter)	Expand generating capacity and develop plant facilities	Dept. of Treasury and Overseas Advisory Associates Inc.; Min. of Finance and National Economy	4
Agricultural Bank Management Training (AGRIBANK)	11-18-78 (5 years)	Establish training programs and provide advisory services	Farm Credit Admin.; Saudi Arabian Agricultural Bank	7
Transportation Services (TRANSNET)	11-18-78 (4 years)	Provide technical, management, training and financial analysis services	Dept. of Transportation Min. of Communications	2
Executive Management Development (DEVEX)	11-18-78 (Indef)	Develop executive and managerial effectiveness of selected government officials	Dept. of Treasury; Min. of Finance and National Economy	0
Arid Lands, Meteorology and Environmental Education (ARMETED)	11-25-79 (Indef)	Curriculum development and teaching assistance	Dept. of Treasury and Consortium for International Development (S.W. univs.); King Abdulaziz University	5
Cooperation with King Faisal University (JAMIAH)	4-15-80 (4 years)	Provide university planning and administration	Dept. of Treasury and contractor to be selected; King Faisal University	0

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U.S. Representation Office (USREP)		Supervision, management, and support services	Dept. of Treasury; Min. of Finance and National Economy	11
			Total U.S. Professional Staff	215

COMPLETED PROJECTS

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Procurement and installation of power generation equipment and warehouses	Dept. of Treasury and Overseas Advisory Associates, Inc.; Min. of Finance and National Economy
Procurement of electrical power equipment for Eastern Province	Dept. of Treasury and Overseas Advisory Associates, Inc.; Saudi Consolidated Electric Company (SCECO)

QUESTION: A review of Treasury and other documents indicates that OPEC governments have expressed a desire for indexed government or other securities, so that the real rate of return would be maintained. (The principal would be indexed to a general price index.) Has the U.S. Government issued any such indexed securities? Have any U.S. businesses or banks issued any indexed securities or financial instruments? If so, please describe the securities involved, their terms, the amounts involved, and the recipient.

ANSWER: The U.S. Government has not issued any indexed securities.

Some U.S. preferred stock or convertible debentures have been issued where the return is linked to an index of prices for a commodity, such as crude petroluem, to Treasury bill rates, or to other indexes. To our knowledge U.S. businesses or banks have not issued securities or financial instruments linked to a general price index, such as the consumer price index (CPI), and we understand that underwriters probably would recommend against it except for a firm whose profits were directly related to the CPI. Interest payments generally have been linked to an index that incorporates elements likely to be correlated with the firm's performance.

QUESTION" In 1979 Treasury furnished a table, "Estimated Foreign Holdings of U.S. Public Debt Securities, All Foreigners and by Selected Foreign Countries, as of December 31, 1978", attached. We would like that table updated with the most recently available data, including "Middle East OPEC countries" as a separate country category.

ANSWER: See the following tables.

Estimated Foreign Holdings of U.S. Public Debt Securities, All Foreigners
And by Selected Foreign Countries, as of June 30, 1981
(in millions of dollars)

Type of Security	Total, All Foreign 1) Holdings	Total Selected Countries	Germany	Japan	Switzerland	France	U.K.	Italy	Sweden	Canada	Netherlands	Denmark	Middle East Oil Exporters 3)
1. Treasury bills and certificates													
a. marketable	55,926	43,743	7,659	14,585 4/	5,489	7,214	877 4/	1,361	1,384	907	643	137	7,193 4/
b. non-marketable	3,705	3,705	-		-	-		-	-	-	-	-	
2. Treasury bonds and notes													
a. marketable 2)	53,493	45,331	7,036	9,128	73	482	5,839	7	559	443	1,858	50	19,856
b. non-marketable	19,639	19,639	18,436	-	1,203	-	-	-	-	-	-	-	-
3. Agency securities 2)	9,610	8,896	151	137	26	30	2,970	3	25	55	1	22	5,476
TOTAL	142,373	121,314	33,282	23,850	6,791	7,726	9,686	1,371	1,968	1,405	2,502	209	32,525

1) Includes international and regional organizations.
2) Estimated holdings figures derived by applying TIC Form S transactions data to 1978 FPIS benchmark data.
3) Includes Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, and the UAE.
4) A separation into marketable and non-marketable components would tend to divulge holdings of individual countries under Foreign Military Sales Agreements.

Treasury/OASIA/IR/IRI
September 17, 1981

U.S. Public Debt Securities Held by Oil-Exporting Countries
As of Ends of Selected Periods, 1978-1981
(millions of dollars)

End of Period	Treasury Bills and Certificates Marketable	Treasury Bills and Certificates Non-Mkt.	Treasury Bonds and Notes Marketable	Treasury Bonds and Notes Non-Mkt.	Agency Securities	Total
1978						
Ecuador	9	-	*	-	*	9
Indonesia	69	-	*	-	1	70
Venezuela	9	-	5	-	*	14
Middle East Oil-Exporting Countries1/	2,316	-	7,968	-	3,031	13,315
African Oil-Exporting Countries2/	894	-	668	-	*	1,562
TOTAL	3,297	-	8,641	-	3,032	14,970
1979						
Ecuador	16	-	*	-	*	16
Indonesia	*	-	*	-	1	1
Venezuela	1	-	*	-	*	1
Middle East Oil-Exporting Countries1/	5,868 3/		6,954	-	2,948	15,770
African Oil-Exporting Countries2/	752	-	568	-	*	1,320
TOTAL	4,788	1,849	7,522	-	2,949	17,108
1980						
Ecuador	19	-	*	-	*	19
Indonesia	95	-	*	-	1	96
Venezuela	6	-	189	-	*	195
Middle East Oil-Exporting Countries1/	5,919 3/		14,626	-	4,398	24,943
African Oil-Exporting Countries2/	1,978	-	895	-	-	2,873
TOTAL	5,421	2,596	15,710	-	4,399	28,126
1st Qtr. 1981						
Ecuador	33	-	*	-	*	33
Indonesia	259	-	*	-	1	260
Venezuela	2	-	189	-	*	191
Middle East Oil-Exporting Countries1/	6,167 3/		17,388	-	4,935	28,490
African Oil-Exporting Countries2/	1,885	-	1,115	-	*	3,000
TOTAL	5,121	3,225	18,691	-	4,936	31,973
2nd Qtr. 1981						
Ecuador	*	-	*	-	*	*
Indonesia	67	-	*	-	1	68
Venezuela	4	-	184	-	*	188
Middle East Oil-Exporting Countries1/	7,193 3/		19,856	-	5,488	32,537
African Oil-Exporting Countries2/	1,000	-	1,115	-	*	2,115
TOTAL	4,859	3,405	21,155	-	5,489	34,908

1/ Includes Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia and UAE.
2/ Includes Algeria, Gabon, Libya, and Nigeria.
3/ A separation of non-marketable bills and certificates would tend to disclose holdings of individual countries under FMS Agreements.
* Less than $500,000.

SOURCE: Treasury FPIS benchmark data as of the end of 1978; TIC Form S transactions added to benchmark data for subsequent periods.
Treasury/IRI September 17, 1981

Mr. ROSENTHAL. Our next witness is Governor Henry C. Wallich of the Federal Reserve System.

Governor Wallich, we apologize for the delay in the opportunity to hear your testimony, but we are keenly interested in it.

STATEMENT OF HENRY C. WALLICH, MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. WALLICH. I am very pleased to have this opportunity to testify before your subcommittee on the topic of the evolution of OPEC investments and their effects.

The Federal Reserve has supplied to the subcommittee a great deal of information on this subject from our files over the past year, and your letter raises a number of questions regarding this material. Questions of a statistical nature are covered in the annex to my testimony.

As available data have become progressively better and more complete, some statistical questions have diminished, and some policy issues have become of less immediate concern. In my testimony, I shall review the evolution of the OPEC surplus and the effects of OPEC investment decisions on financial markets and the banking system.

Turning first to the evolution and impact of the OPEC surplus, the Federal Reserve staff estimates that, over the 7 years from 1974 through 1980, inclusive, OPEC had a cumulative current-account surplus of almost $350 billion. The exact number is $337 billion, to be taken exact, of course, with proper precautions. This figure includes public transfers from OPEC countries to other countries and, thus, is somewhat smaller than the cumulative surplus on goods, services, and private transfers alone.

Over the years, the OPEC current-account surplus has gone through several distinct periods. The increase in the price of oil from less than $3 per barrel in 1973 to around $11 per barrel in 1974 produced a current-account surplus of $70 billion in 1974. In the next 4 years, the price of oil rose much more slowly while OPEC imports continued to increase very rapidly.

After being in the $30 billion to $40 billion range in 1975-77, the OPEC current-account surplus disappeared in 1978. The renewed very large oil price increases in 1979–80 raised the price from $13 per barrel to the range of $30 to $40 per barrel, and the OPEC surplus has re-emerged larger than ever, reaching more than $100 billion in 1980. This year the surplus has diminished as oil demand has weakened and OPEC imports have risen further. Our staff projections suggest the 1981 surplus will be about two-thirds as large as last year.

Because the OPEC countries have had an aggregate current-account surplus in the past 7 years, the rest of the world in the aggregate has had a current-account deficit. The uneven distribution and uncertain financing of this deficit has been a major source of economic strain for many oil-importing countries.

When the OPEC surplus emerged on an enormous scale in 1974, concerns were expressed both about the ability of oil-importing countries to deal with their sharply higher oil bills, and about the effects of OPEC investment decisions on international banking and the international financial system. As the situation has developed, it is clear that to date the problems of coping with the effects of increased oil bills—high inflation, depressed activity, efforts to restrain oil consumption and rising debts to finance oil-related deficits—have been more serious than any problems that have been associated with the investment of OPEC reserves.

I turn now to the investment of the OPEC surplus.

Our experience with OPEC investment decisions over the past 7 years has shown that these investments have not disrupted financial markets substantially. Moreover, information about these investments has improved over the years.

By and large, while individual OPEC countries may tend to concentrate on one broad type of investment in preference to others, OPEC investments in the aggregate have been quite widely distributed.

Our information on OPEC investments comes primarily from reports by U.S. financial institutions and from the Bank of England, whose data and estimates have been published by the Bank for International Settlements [BIS]. The quality of the data has improved very considerably in recent years. As a result of these improvements in the data, we are now able to account for virtually all of the OPEC surpluses.

For example, our earlier estimates of total OPEC investments in the 6 years 1974–79, aggregating $240 billion, contained an unidentified component of more than $70 billion—30 percent of the total. Now, using the improved information published by the BIS, we estimate the aggregate unidentified component at $8 billion for those 6 years combined, only about 3 percent of the total. Most of the reduction in the unidentified component comes from improved reporting of OPEC investments in continental Europe, Japan and developing countries rather than from OPEC investments in the United States.

The published data identify the main types of OPEC investments over the years. For the period 1974–80, a little under 20 percent of the cumulative OPEC current-account surplus in those years was invested in the United States, mostly in U.S. Treasury and other securities. Another 40 percent of the total has gone into Eurocurrency deposits in industrial countries. And as shown in the table in the statistical annex, the remainder was invested in a variety of forms in several locations.

Our information on the investment strategies of OPEC countries is based primarily on the regular statistical reports that I have already mentioned. In some cases, these reports can be supplemented by qualitative information from press reports or market sources. Available statistics show that most OPEC countries invest heavily in short-term instruments—about half of the total OPEC surplus of the past 7 years has been placed in securities with maturities of a year or less.

From published BIS figures, it is clear that Iraq and Venezuela hold large amounts of bank deposits outside the United States, as do Kuwait and Saudi Arabia. On the other hand, Kuwait is known to have purchased equity securities and real estate as well, and Saudi Arabia has purchasesd longer-term government securities and some less amounts of corporate securities and notes.

Now, what are the effects of OPEC investment decisions? OPEC investment decisions have had far less impact on the economies and financial markets in the rest of the world than have the inflationary consequences of OPEC oil pricing policies. In principle, we would not expect OPEC investments to affect significantly the general level of dollar interest rates, which is determined primarily by financial and economic conditions in the U.S. economy. Moreover, the levels of U.S. monetary aggregates are the result of Federal Reserve policy decisions, and cannot be thrown off course by OPEC investments.

Broadly speaking, whether OPEC investment decisions have an effect on the prices of particular financial assets and the interest rates on those assets depends on whether OPEC preferences for financial assets differ from those of other investors. At times in the past, we have observed that interest rates on U.S. Treasury bills have shifted relative to other U.S. moneymarket rates when there were large foreign official purchases or sales of Treasury bills.

These temporary influences on Treasury bill rates were usually the result of rapid changes in dollar reserves of industrial countries that were associated with intervention in foreign exchange markets. In principle, the same sort of effect on relative interest rates could be produced if OPEC investments were concentrated in, or withdrawn from, any single type of asset. In fact, as I have already noted, OPEC investments have been spread over a range of financial assets, both in the United States and in overseas financial markets, and we have no evidence to suggest that OPEC placements have had a significant impact on relative interest rates on different assets in the United States or on differentials between U.S. and foreign interest rates.

OPEC investment decisions are also capable of affecting exchange rates. However, it should be emphasized that exchange rates have been affected primarily by other factors. In particular, the sharp exchange rate movements that have occurred in the past year—notably the appreciation of the dollar relative to the German mark and other continental European currencies—essentially reflect developments in the major industrial economies and their financial markets. While funds of OPEC investors are large, they are only part of the enormous volume of financial resources involved in international financial transactions.

To the extent that shifts of OPEC funds do affect exchange rates, the impact would be the same as that of shifts of similar magnitudes from other sources. In that connection, it is useful to bear in mind that U.S. exports and imports are each running at a rate of $20 billion per month, and Japanese and German exports and imports at $10 billion to $15 billion per month. A decision by international traders to shift the pattern of trade financing by 1 month in response to interest rates—for example, delaying payment for one country's imports by 30 days and accelerating receipts of exports—would produce very large flows of funds.

Anecdotal evidence suggests that OPEC countries as a practical matter adjust the composition of their foreign currency reserves by directing new receipts into the desired currency, rather than by drawing down existing investments and transferring the proceeds into assets denominated in another currency. This practice tends to minimize any disruptive effects on foreign exchange markets, which OPEC countries recognize would likely result in large capital losses on their financial assets.

The fear, often expressed in the mid-1970's that OPEC would seek to shift rapidly from one currency to another has not been realized. In general, OPEC countries have acted as rational investors, interested in preserving and adding to their capital, and on occasion OPEC investments have contributed to stabilizing exchange rates, for example, making sizable investments in Germany and Japan in the past year or so when Germany has had a current-account deficit and the mark and yen have depreciated.

On the whole, OPEC does not appear to pose special problems for the multicurrency reserve system. We should, of course, be alert to the possibility that politically motivated actions by an OPEC country could lead to disruptions, but this possibility is not limited to OPEC countries.

Mr. ROSENTHAL. The distinction there is, some of the OPEC countries have these vast resources, while non-OPEC countries do not.

Mr. WALLICH. Yes; that is true, Mr. Chairman, although when you look at the amounts spent by Japan and Germany in defending their respective currencies, last year they ran into very large numbers.

OPEC investments could have the greatest potential for being disruptive if they were made without regard to their market impact. In a "thin market," an effort to place large sums could produce exaggerated price movements and, in fact, over the past years we have seen dramatic swings in the prices of a number of commodities as investors have moved in and out. But these swings were not the result of OPEC decisions, and evidence suggests that, by and large, OPEC is interested in making profitable investments in broad, liquid markets, rather than seeking to bid up the price of assets in more specialized markets. Thus, these countries appear to be following investment policies designed to assure a source of foreign earnings against the day when they may have to rely less on current receipts from oil.

As you know, evidence is mounting that the OPEC surplus will decline from the 1980 peak of more than $100 billion. Although based on the latest available estimates, it would be premature to conclude that the surplus will soon disappear.

The experience of 1978 provides an illustration of the economic effects of a declining surplus. OPEC purchases of imported goods and services continued to grow, while OPEC receipts from oil were little changed. Industrial countries experienced increased exports and strengthened demand, and current-account deficits of most oil importers were reduced and in some instances replaced by surpluses. The country-by-country pattern of such shifts would be difficult to anticipate; in 1978, Germany and Japan experienced large current-account surpluses.

As I have indicated, a slowing of the price rise for oil and a corresponding reduction in the OPEC current-account surplus would have an important beneficial effect on the economies of industrial and developing countries alike. Continued growth in OPEC imports would help oil-purchasing countries move to more

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sustainable external payments positions, particularly if these developments occurred in a period when industrial countries generally had excess capacity and inflationary pressures were slowing.

A sharp decline in the overall OPEC surplus would doubtless mean that some OPEC countries would become borrowers on an increasing scale, and also draw down their reserves. Because Saudi Arabia accounts for a large share of the present OPEC surplus, a shift in its position sufficient to eliminate its surplus and to result in a major drawdown of Saudi reserves would appear to be a remote possibility. Instead, I would anticipate that, in coming years, Saudi Arabian reserves would grow at a slower pace than in recent years, and that its development policies would be adjusted to the new circumstances. However, some countries with smaller oil exports may be running down their reserves in the period ahead.

As for the significance of OPEC investments for the banking system, the large volume of OPEC funds that has been invested in bank deposits has focused public attention on the role of the commercial banking system, both as an outlet for investment and as a source of funds for lending to oil-importing countries. Banks have played a major role in the recycling of OPEC surpluses, but we need to insure that the recycling process does not result in an overloading of the commercial banking system. In part, this can be achieved by seeing to it that there are alternatives to commercial bank lending—through the IMF and other international organizations, as well as through credits from national governments, including those of the oil-exporting countries. And in part we can avoid an overloading through our supervisory procedures.

One of the foundations of our bank supervisory process is the principle of diversification. This is appropriate on both the deposit side of the balance sheet and the loan side. The Federal Reserve System examination report contains a schedule that shows large deposits as a percentage of the bank's total deposits. Examiners review the accounts of large depositors to analyze their maturity structure as it might affect a bank's funding operations, although information on individual accounts is not included in the examination report.

I should note that OPEC deposits do not appear to represent an unduly high share of the deposits of U.S. banks in general, or of the large U.S. banks. As shown in the table in the statistical annex, deposits of Middle East oil producers represent less than 5 percent of total deposits of the largest U.S. banks, and much smaller percentages for other large banks.

The major banks that accept large amounts of deposits from OPEC are generally aware of the desirability of maintaining diverse sources of funding. Banks with high levels of OPEC deposits frequently have systems to monitor the levels and movements of those deposits. In some cases, banks set limits on the amount of deposits they will accept from any one source. Banks may occasionally refuse deposits from a large depositor, although they are more likely to discourage deposits by offering low rates.

The fact that U.S. banks participate actively in the international interbank markets is a valuable element of insurance against sudden deposit withdrawals by one or several major depositors. When such withdrawals have occurred, the funds have been redeposited in another international bank, which then has funds available for lending to the U.S. bank that suffered the deposit loss.

With respect to lending, international or domestic, diversification of portfolios is an essential element of prudent banking, and the country exposure system of the three Federal bank supervisory agencies is based on this principle. Under that system, the exposure of individual banks to particular countries is measured against the capital of the bank. The ratio to capital is not a limit—voluntary or otherwise—but, rather, a signal that the position of the bank should be considered closely by bank management.

The significance of a particular ratio of loans to capital depends on the overall position of the country, the nature of the lending—whether it is short-term trade financing or long-term credits—the identity of the particular obligor, and collateral. In a recent speech, I noted that the number of banks with exposures of more than 30 percent of capital in developing countries has jumped substantially during the past 18 months. I regard that not as a sign that the system is breaking down, and certainly not as a sign that banks have overstepped prudent boundaries; but, rather, as a situation that bears careful watching. That, of course, is the essence of prudent banking.

Your letter refers to a point that has been of concern to me—that the margins on syndicated international credits have declined to the point at which banks may not be covering the risks involved and also obtaining an adequate return on capital. While margins on some Euroloans have been increased for particular borrowing countries over the past year, some widening of margins generally would appear appropriate if banks are to continue to provide sizable amounts of funds to borrowing countries.

The shortage of bank capital is one potential impediment to expansion of banks' international loan portfolios at a rate sufficient to keep pace with the credit demands of oil-importing countries. One way of conserving capital that appears promising would be for banks to act as brokers instead of lenders of funds, arranging loans for OPEC investors for a fee, with the investor bearing the credit risk. Prototypes for such techniques may be found in the United States, where banks have created mortgage-backed pass-through securities, and in Switzerland, where banks provide funds through trustee accounts.

Both techniques have the effect of economizing on bank capital and of taking advantage of the banks' expertise in international financing. I have no direct knowledge that OPEC countries would be receptive to such an approach, but in the interests of selling their oil, they might at some point be prepared to extend some credit in this fashion, particularly if the arranging bank were also to participate in the credit.

Conceivably, a developing country might be willing to do what developed countries have firmly resisted—indexing debt securities issued to OPEC investors. This indexing—presumably using a price index related to the currency of the loan—could be accompanied by a very moderate interest rate, and the combination would constitute a positive rate of return.

In closing, let me comment briefly on concerns that are sometimes voiced regarding contingency plans in the international banking environment. The Federal Reserve makes loans to solvent U.S. banks on the basis of sound collateral. The Board has established guidelines to aid in the administration of the discount window, from which these loans would have to flow.

The large money market banks that are engaged in international lending would be expected to make use of their other sources of liquidity before coming to the Federal Reserve for liquidity assistance. In developing policies regarding such emergency assistance, the Board has not believed it would be useful to set quantitative limits or targets for the amounts of the assistance. Instead, the amounts would be determined in the light of circumstances at the time, in conformity with Board guidelines and statutory responsibilities.

Mr. ROSENTHAL. Thank you very much, Governor.

On page 2, you say your experience with OPEC investment decisions over the past 7 years has shown these investments have not disrupted financial markets substantially.

Have they disrupted them at all?

Mr. WALLICH. Very minor fluctuations in interest rates that one wouldn't even know about. It might be possible. The general experience was that in 1974, when these things began, everybody was watching like a hawk where the money was going, who was getting it, what was being done with it, and it turns out that it was uninteresting information.

The markets have just recycled it, and wherever the money went, some other money yielded and went someplace else, and the overall level of interest rates and supply of funds remained pretty stable.

Mr. ROSENTHAL. What does the Board estimate to be the total amount of OPEC investment in the United States?

Mr. WALLICH. I think it is about 20 percent of the total of not quite $350 billion, or in the order of $60 billion.

Mr. ROSENTHAL. Suppose a scenario developed that one country eventually had invested $1 trillion. Do you foresee such a scenario possible in 5 years?

Mr. WALLICH. No, I don't; because I would ask myself where was that trillion dollars coming from. Presumably, they would have to have a current-account surplus, and we would have to have a deficit, or the rest of the world would have had to have a deficit of that magnitude.

What we have seen in the past is that the OPEC surplus can go up and down, but we also see that when it gets very large, it imposes severe constraints on the economies of the oil-importing countries, so that one cannot simply assume that it could go to hundreds of billions.

Mr. ROSENTHAL. What was the OPEC surplus account for 1979–80?

Mr. WALLICH. In 1980, it was a little over $100 billion. In 1979, it was still building up from that price increase. In 1978, it was practically zero.

Mr. ROSENTHAL. If it were about $100 billion, it is not inconceivable that in 10 years you could reach $1 trillion?

Mr. WALLICH. First, this assumes that it all goes into the United States, and as we know, we only have about 20 percent; but suppose you try to foresee such a scenario. OPEC acquires assets because the United States and other countries are not independent of oil. We are making a very great effort nationally to reduce our oil dependence, so I would think in terms of the volume of oil, oil imports would go down over time.

The question of price, of course, nobody can predict. We have seen enormous jumps. We do know that the Saudis are working toward a gradual rise in the price of oil, so that the real price after adjustment for inflation—it would be rising at a moderate rate. If that were the case, and we are reducing our oil imports, I would think that the current-account surplus would diminish. Meanwhile, you have to bear in mind, as the OPEC countries keep selling, they also keep buying. Their purchases tend to increase more rapidly as the economies build up sales.

Mr. ROSENTHAL. Their purchases are not going to increase anywhere in comparison to their sales? Their infrastructure is nonexistent to permit that?

Mr. WALLICH. There are the high absorbers and the low absorbers, and the high absorbers haven't got that much of a surplus now. They were in deficit before the price increase. The low absorbers are building up their economies very rapidly, and I would think that if the price of oil moves as I have suggested, which is a very big issue, of course, then the OPEC surplus will go down. It is already moving down, and under present circumstances we are estimating that in 1981 it will be two-thirds of 1980; that is, it will be in the $60 billion range.

If you project this surplus, and it becomes increasingly uncertain into 1982, it would be something like one-half or two-thirds of what it was in 1981.

Mr. ROSENTHAL. Why do you say it will be one-half of what it was in 1981?

Mr. WALLICH. Because of our continuing efforts to reduce our dependence on oil and because of the rapid buildup of their imports. Because they start from a relatively low level, they are able to increase their imports at a high percent.

Mr. ROSENTHAL. Their imports are arms.

Mr. WALLICH. Part of them.

Mr. ROSENTHAL. Well, they are prepared to spend $8.6 billion for openers this year, the Saudis are. That is more than all their other imports.

Mr. WALLICH. I don't have the data on the Saudi imports here, but I know they have a large development program and I would think that their imports must grow—I don't want to throw out vague numbers—but I would be glad to get you the numbers, Mr. Chairman.

[Material referred to follows:]

Governor Wallich subsequently submitted the following information for inclusion in the record of the hearing:

Saudi Arabian merchandise imports were: $2 billion in 1973; $6 billion in 1975; and $25 billion in 1979.

Source: International Financial Statistics of IMF (page 377).

Mr. ROSENTHAL. Are you satisfied with the reporting requirements we have in this country?

Mr. WALLICH. Broadly speaking, yes, Mr. Chairman. My concern is that in many respects we demand too much.

In my opinion, the banking system in particular is overregulated and overreported. Now, we may not always get the right things and the things we need, but bear in mind that in order to get the things you need here for OPEC-oriented reports, you have to make everybody else report. In other words, if you want to know whether an OPEC citizen has bought some investment in the United States, you cannot just say, "Let all OPEC citizens report whenever they buy an investment." You have to say, "Let all American citizens report," and in that way you spread the net and you catch them.

Well, that leads to our present requirements for changes in banking control which are very burdensome, in my opinion, speaking from my personal opinion.

Everybody who wants to buy even a modest share of a bank needs to report. If we apply similar standards for every OPEC investment, we would have terrible investment requirements for our own nationals.

Mr. ROSENTHAL. Do you think it is good for foreign investors to be buying U.S. banks?

Mr. WALLICH. It is good for foreign investors to buy U.S. assets. Banks are in a somewhat special category, but in many instances I think that is good, too, because our banks, as you know, suffer from a lack of capital, low capital ratios, and in many cases the stock is selling below book value, and every injection strengthens that.

Mr. ROSENTHAL. Is there any truth to the rumors that they own all the banks in particular communities, such as in upstate New York, for example?

Mr. WALLICH. It seems very unlikely that this would happen. If it did, it would certainly be known under our reporting system.

The studies we have made of the effects of foreign ownership show nothing untoward. They show an improvement in the capital position of banks, an improvement of the earnings position. In general, the banks bought by foreigners—not all, but many—had low capital and low earnings.

There has been some movement away from consumer loans, and an increase in commercial and industrial loans.

These are all very small but statistically traceable changes.

Mr. ROSENTHAL. You said that you found that the regulations for purchasers of bank stocks were burdensome. Could you tell us what you meant?

Mr. WALLICH. Well, everybody who wants to buy any signficant part of a bank's stock, I think it is 10 percent, must notify the Fed in advance. He has to file a substantial report with a lot of detail about his background, assets, qualifications, and so forth.

I think in a free economy such as we want to have, this is burdensome. Maybe it is necessary. It happens once in a while that somebody who, it turns out, will mismanage his bank, buys a bank. Then you have a bad case, but you have to count the costs of making other people who will manage their bank better than the previous owner go through these motions.

Mr. ROSENTHAL. If a bank is mismanaged and has a lot of problems, it is disruptive to the entire community?

Mr. WALLICH. If it were the only bank in the community, it would do them some damage. Typically, the examination process will pick that up before anything serious happens, and, of course, the bank is not going to simply disappear, because there is the FDIC, which in a case of a failure would take care of the depositors up to $100,000. There is the Federal Reserve, which in the case of a liquidity problem, will help.

Mr. ROSENTHAL. That really has nothing to do with this. You think it is burdensome for a purchaser of 10 percent of a bank, and such a person would have accountants and lawyers who would prepare his statement, and that is burdensome, even if a whole community is disrupted. Well, how do you feel about licensing barbers?

Mr. WALLICH. I don't frequent barbers much, so I would be quite willing to have them unlicensed.

Mr. ROSENTHAL. If a barber does any damage, it is usually 1 to 1. If a bank does any damage, a lot of people get hurt.

Mr. WALLICH. Yes, that is true. On the other hand, you cannot be completely sure, even though the man or woman has filed all these forms, that he is going to do it right; in the end, we can only hope.

Mr. ROSENTHAL. We have the story about the doctor who left the sponge in. Well, anyhow, you are satisfied with the way everything is going?

Mr. WALLICH. No, I am not satisfied. Everything can be improved in many ways, but I don't think in this particular area—I presume you are still talking about OPEC investment—that we are underinformed. I think we have made very considerable progress in terms of the data, and at the same time we have found that as we got more data there was less to find and less significance than we had originally supposed.

Mr. ROSENTHAL. Thank you very much. Mr. Neal?

Mr. NEAL. Governor Wallich, does the Federal Reserve maintain independent data collected independently of the Department of the Treasury on Middle East investments in this country?

Mr. WALLICH. We have some data. We get data from foreign branches of U.S. banks, and the Treasury Department collects the domestic data. We turn this over to Treasury.

Mr. NEAL. Each of you gather different parts of the information that you feel is necessary, and then share your information with each other?

Mr. WALLICH. That is right. Our information, without the other, is not very meaningful because funds can, of course, go to the head office or to a foreign branch and it does not have any significance economically other than that the reporting, or a different reporting system, would pick it up.

Mr. NEAL. You are comfortable with the data that we have?

Mr. WALLICH. Yes. I think the data have improved a great deal.

As you know, much of what we know about OPEC in general comes from other sources, from the Bank of England, and they in turn get it from a broad base of sources.

It is not unusual to try to avoid duplication; various banks trying to do the same thing. We are engaged in a great effort to reduce the reporting burden, bring it down 25 percent by the end of 1983. Every little bit more we get in one place costs something else in terms of capacity to collect information.

Mr. NEAL. Are you familiar with the agreements under which we have agreed not to release country-by-country information concerning investments in the United States by Middle Eastern countries, and if you are, do you see that there would be any damage done if that data was released country by country instead of in the aggregate?

Mr. WALLICH. My knowledge is very scanty, but I know that the Federal Reserve or any other central bank would not release information on individual depositors.

Now, that is the nature of our situation with respect to OPEC countries. In countries where, if we release the total country information we are actually pointing the finger at one big depositor, one would be violating this principle that one does not release information on a single depositor. Taking other factors into account, one could compute what one single depositor had, and that is why we do not report single countries for OPEC.

However, I would suggest to you that since OPEC is a group, and since you know anyway that the Saudis are a very large part of this, and Kuwait is the next, it really does not matter a great deal whether you know which country has what amounts.

Finally, I would say, particularly in the case of OPEC, if it should ever happen that they want to put great pressure on it, they could do it easier by oil than by damaging their own investments. Economic rationality suggests that they do it with their oil and not with their money.

Mr. NEAL. Does it surprise you that only 20 percent of OPEC investments are in the United States?

Mr. WALLICH. Frankly, I think some things may have caught their attention that make them reluctant to put as much money here as they might, but you would also want to bear in mind that what they have abroad in the Euro market is in good part in dollars, so even though it is not in the United States, it is in our currency and it has the effects with respect to the exchange rate, interest rates, and so forth.

Mr. NEAL. What sort of things were you referring to that might discourage investment?

Mr. WALLICH. No other country has tried to look that closely into their business.

Mr. NEAL. As closely as we do?

Mr. WALLICH. As we do.

Mr. NEAL. Would it be beneficial for us to have a larger share of that total investment?

Mr. WALLICH. We thought that originally in 1974. But it turns out that the money spreads around.

Now, I wouldn't say there wouldn't be specific effects from their wanting to go into dollars rather than wanting to go into yen or marks, or from going into U.S. Treasury bills, or wanting to go into equities. All of these will have some effect, depending on the elasticity of demand and supply in that particular market. In general, I like to see capital imports as much as possible.

We are a very low-saving economy. Of the $107 billion or so net saving which we have, which is 5 or 6 percent of our GNP, the Government uses one-half for its deficit, so we have to be very glad to get any foreign capital.

Mr. NEAL. Well, if I understand by implication, what you are saying is, should the OPEC countries, any one of the group, as a group, rather precipitously move a lot of their investment out of the country, and if it were moved into the Euro currency markets, it probably would not have any great effect, then, on our economy. Would that not be correct?

Mr. WALLICH. That is correct, and it is likely to go into that market; there are not many other places in the world where you would put large amounts.

Mr. NEAL. It would come back to our market rather immediately.

Mr. WALLICH. It would go into non-U.S. banks, offshore centers, and those would have to place it somewhere. They would place it where they would get the best bid, and that would be presumably from the banks that lost the deposits.

Mr. NEAL. There really wouldn't be any other market large enough to accommodate any kind of large shift in funds, would there?

Mr. WALLICH. Yes; it has been shown to be very difficult to get into the markets in large scale that are otherwise attractive. Typically, Germany, Japan, and Switzerland, the amounts that can be absorbed there are limited.

Mr. NEAL. Since we are so interdependent, even if there were an attempt to place large sums in any of those countries, they would probably find their way back here also, or into the Euro market?

Mr. WALLICH. Quite likely the currencies of those countries would be driven up, but the money might very well flow out again through other channels.

Mr. NEAL. Exchange rates might be affected somewhat, but other than that, currency would still flow as it would, either in our market or in the Euro market; maybe a little slower?

Mr. WALLICH. I would think so, yes.

Mr. ROSENTHAL. Thank you very, very much, Governor Wallich. We appreciate your testimony.

[Chairman Rosenthal's letter to Mr. Wallich and his response appear in the following statistical annex:]

BENJAMIN S. ROSENTHAL, N.Y., CHAIRMAN
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NINETY-SEVENTH CONGRESS

Congress of the United States

House of Representatives

COMMERCE, CONSUMER, AND MONETARY AFFAIRS
SUBCOMMITTEE
OF THE
COMMITTEE ON GOVERNMENT OPERATIONS

RAYBURN HOUSE OFFICE BUILDING, ROOM B-377
WASHINGTON, D.C. 20515

July 16, 1981

Hon. Henry C. Wallich
Governor
Federal Reserve System
Washington, D. C. 20551

Dear Governor Wallich:

The Subcommittee on Commerce, Consumer, and Monetary Affairs of the Committee on Government Operations is continuing to examine (1) the adequacy of Federal efforts to monitor, analyze, and report on OPEC country and other portfolio investment in the United States and (2) the nature, extent, and impact of such investment on the world's and the U.S. economies.

On July 29 and 30, 1981, the subcommittee will hold hearings, and I request that you appear and testify on July 30. The hearing will begin at 10 a.m. in Rayburn House Office Building, Room 2203. (Subcommittee Counsel Stephen R. McSpadden has already been in contact with Donald Winn, Assistant to the Board for Legislative Affairs, to discuss your scheduling on the 30th.)

Your testimony should respond specifically to the following requests and questions, furnishing examples and data where appropriate.

<u>OPEC Country Investible Surpluses</u>

We require information about the amounts and distribution of OPEC investible surpluses and unidentified flows of such surpluses:

1. Describe the Federal Reserve's estimates of total cumulative OPEC investible surpluses, showing by investment and other categories the estimated disposition of the surplus. Also, set forth the estimated total surplus for each OPEC country.

2. The 51st Annual Report of the Bank for International Settlements (BIS), June 15, 1981, discussed the overall disposition of the OPEC current account surpluses in the past and present.

   a. Expand and place in an appendix to your testimony the table found on page 97 of the report, "Estimated Deployment of OPEC Countries' Investible Surplus, 1974-75 and 1979-80," to include data for the years 1976, 1977, and 1778, as well. Please define the BIS use of the terms "long term" and "short term" investments.

   b. In your testimony, compare the patterns and tendencies in the placement of OPEC surpluses observed by the BIS, with the Federal Reserve's observations. Does the Federal Reserve agree with the BIS' assessment or does it have different or additional views? If so, what are they?

3. We are concerned about unidentified OPEC investible surpluses, differing estimates about them, and the reasons for them. During a speech in March 1980 at New York University, Chairman Paul Volcker reported that as of year end 1979, there was approximately $75 billion that had not been identified as foreign official holdings of OPEC countries and that this amount was invested in ways that our statistics did not pick up.

A summary of a November 23, 1977, Treasury memo to a Treasury assistant secretary, (Doc. No. E 11), furnished to the subcommittee, states:

> Knowledgeable persons who handle these accounts have told us that most OPEC countries, including /a major/ Middle East OPEC country, do not give them a breakdown of the types of foreign exchange reserves which they hold; however, it is their opinion that these countries have been underreporting their holdings for political purposes. Our figures seem to provide substantial evidence for this assumption.

Furthermore, it appears that either this failure to report or under-reporting on U.S. Government surveys, particularly Treasury surveys, may have contributed to a very large gap in the U.S. balance of payments. In 1979 and 1980 the statistical discrepancy in the U.S. balance of payments accounts, reported by the Commerce Department, reached a total of $60 billion, most of which could have been caused by unreported and unidentified capital inflows. (In June 1981, an interagency working group, on which the Federal Reserve is represented by Lois Stekler, issued the "Progress Report of the Interagency Work Group on the Balance of Payments Statistical Discrepancy".)

a. At present, what does the Federal Reserve estimate the cumulative total unidentified OPEC investible surplus to be and which countries most account for this?

b. What categories of investible surpluses do the surplus Middle East governments underreport or fail to report? Are there problems with other OPEC governments' reported statistics? Is there any action which the U.S. Government can take to improve this reporting?

c. What are the Federal Reserve's views on the extent to which the $60 billion of probable unidentified capital inflows into the U.S. may be part of the unidentified OPEC surpluses? Is there any way to resolve this and to locate some or most of this $60 billion?

4. Closely related, the CIA has estimated the size and distribution of OPEC official foreign assets. A February 18, 1977, FED memo, "Getting more data on OPEC investment flows", attached, states:

> The CIA data also have some holes in them for unidentified flows. But they do purport to identify much more than we do. I think it would be worthwhile to explore with CIA the possibility of their furnishing us with more up-to-date information. Treasury should also want more information.
>
> .../The document compares CIA figures with Fed figures/. CIA also comes up with a not insignificant amount of gaps to fill....But this $3.9 billion gap /which the CIA cannot explain/ is only 16 percent of the $23.7 billion of current account surplus and borrowing proceeds to be accounted for, a much smaller residual than we get.

a. How have CIA estimates compared with Federal Reserve estimates for each year 1974 to the Present? (Furnish the figures for each year.)

b. Please explain how CIA was able to find all but $3.9 billion for the period involved, while the Federal Reserve and Treasury were not able to account for a much larger amount.

c. As suggested in the memo, has the Federal Reserve tried to obtain CIA data on a regular basis and has it been able to do so? If not, explain why not. Has the Federal Reserve accepted or rejected CIA's figures in making its final estimates? If it has rejected them, why?

5. Include in your appendix all of the tables (recently furnished to the subcommittee) and the updated August 21, 1979, letter.

OPEC Country Holdings

1. We require the following information: (a) The total OPEC country holdings in foreign branches of U.S. banks as of March 1981, (b) a comparison of that figure with other country holdings, (c) a breakdown of the OPEC total by demand deposits, time deposits, and the remaining categories utilized by the Federal Reserve, and (d) the information to be set forth in the updated August 21, 1979, letter.

2. In reviewing the recent table you furnished to us, we find that from December 1978 to December 1979, OPEC holdings increased from $20.1 billion to $29.2 billion. Yet from December 1979 to December 1980, such holdings only increased to $30.1 billion. Further, between December 1980 and March 1981, these holdings had decreased to $29.3 billion. Describe this decline, explain the reasons for this trend, and indicate where OPEC funds which formerly went into U.S. banks abroad are now being placed.

3. FED Table 1 (July 2 submission) shows $6.6 billion of OPEC country holdings in U.S. bank and money market assets -- all in the U.S. -- as of December 1980. Treasury's recent submission to the subcommittee shows $12.3 billion of OPEC country bank holdings as of the same date. In the appendix to your testimony, explain this discrepancy.

4. In the years 1974 through 1980, how much interest have foreign branches of U.S. banks paid to OPEC countries for their holdings?

OPEC Country Investment Trends and Strategies

1. For those OPEC countries in surplus, we require a country-by-country description of their investment strategies and trends. In your description, indicate the asset compositions, maturity structures, and geographic distribution of the investments, giving percentages where known. (No actual dollar figures are asked for.)

2. We require information about the interagency technical group monitoring international flows of funds. As noted in the October 11, 1974, memo from Undersecretary of Treasury Jack Bennett, to you (and also to CIA, Council of Economic Advisors, and State representatives), this group was created to monitor where OPEC countries place their money, in what types of assets, and the intermediation (recycling) of petrodollars to less developed countries. (The memo is attached.)

a. What is the status of this group and who are its members? If the group is no longer operational, explain when and why it terminated?

b. How does (or did) the group function?

c. What problems or difficulties did the group encounter in monitoring OPEC holdings/investments? What actions or steps did this group recommend and were these implemented by the agencies involved?

Adequacy of the Federal Reserve's Data Collection Efforts

1. The January 17, 1977, Federal Reserve Bank of New York memo to Mr. Fousek from T. J. Giletti, Subject: Saudi Arabian Investments with U.S. Overseas Branches, reveals that data from the Board's "Quarterly Report on Foreign Branch Assets and Liabilities" does not differentiate (a) placements by official foreign institutions and (2) foreign currency or dollar assets, because only an aggregate figure is reported.

   a. Have the quarterly report forms been changed to obtain these two categories of information? If not, why not?

   b. What other problems or difficulties have been observed with this reporting system? Was the Federal Reserve able to resolve them, and, if so, how?

2. To reduce the large statistical discrepancy in the U.S. balance of payments, discussed on page 2, the June 1981 "Progress Report" recommends that Treasury increase reporter awareness of the need to file accurate TIC B, C, and S forms. The Securities Industry Association has informally made a similar recommendation. As the Federal Reserve Bank of New York conducts the TIC surveys for the Treasury, what steps will the Federal Reserve Bank of New York take to assure increased reporter awareness and to enforce compliance?

Impact of and Concerns About OPEC Country Investments

We would like the views of the Federal Reserve on the impact of OPEC country holdings on the U.S. and world economies and the national and international financial markets. Please respond to the following:

1. What are the impact and consequences of OPEC investments in the U.S. and in Euro-dollars on (1) interest rates, (2) exchange rates, (3) credit availability and the Federal Reserve's money supply targets, (4) the stability of the multi-currency reserve system, and (5) destabilizing flows of funds? Does the placement of OPEC funds in the Euro-dollar market rather than in the U.S. market have persistent effects on differentials in interest rates and credit availability in the two markets, and, if so, what are they?

   In discussing these issues, also address the concerns raised in each of the following documents:

   A Treasury official's speech, given on January 11, 1977, states on page 16 (attached):

   > The spread between the interest rate paid to OPEC countries and charged to deficit country borrowers may accurately reflect the risk which the financial system is assuming. But, because in practice there can be no clear-cut distinction between borrowing, the costs of this financial intermediation are probably distributed among all users of financial markets. It is, however, not possible to estimate what this cost might be.

   A Federal Reserve Bank of New York October 28, 1974, memo to Mr. Coombs from Scott Pardee, Subject: Diversification of OPEC receipts into currencies other than the dollar and sterling, states:

   > Among the risks inherent in the accumulation of liquid funds by OPEC members is the possibility of a sudden shift out

of dollars or sterling and into continental European currencies by one or more OPEC central banks. Such a shift could be motivated by the search for higher interest earnings or by fears of a depreciation of the dollar sterling. In our experience and that of others who have dealt with them, the managers of OPEC funds are acutely sensitive to both interest rate and exchange risk considerations. For central banks in a system of managed floating exchange rates, such switches could entail bulky transactions which prove indigestible in the market, causing exaggerated rate movements. More importantly the "diversification" process could very well feed on itself, driving exchange rates to levels unjustified by trade or general economic performance.

A 1974 Treasury research apaper, "A Brief Guide to Oil-Related Financial Problems," states on page 3 (attached):

> -- OPEC deposits will be very large, so that only large banks and capital markets can absorb them. As a result, there may be destablizing flows of funds from smaller banks and money markets to the largest ones in London and New York.... Thus there is a possibility that a number of smaller banks could be confronted with severe deposit drains and/or the necessity of paying higher interest rates to depositors; this is /sic/ turn could force them to increase the riskiness of their loan portfolios in order to stay profitable.

2. Recent articles in the Wall Street Journal (3/30/81 and 5/22/81) indicate that (a) Saudi investible surpluses probably total around $120 billion or a little less, (b) with oil production at 10 M/B/Day, Saudi annual revenues are running around $120 billion, and (c) Saudi expenditures for the fiscal year just ending were around $96 billion. One of the authors of the Journal articles believes that the declining demand for oil and the stabilizing of prices -- assuming no unforeseen political events -- will result in a very substantial reduction of Saudi Arabia's "cushion" of accumulated official foreign assets (both reserves and investments) over a period of two to four years.

   If this scenario proves accurate, and if the types of Saudi purchases of goods and services remain generally the same, increasing only in amounts purchased, what would be the effect of such a draw-down of approximately $120 billion (a) on the stability of the U.S. and international banking systems, (b) the Federal deficit, (c) the value of the dollar, and (d) world's and the U.S.' economy in general? Have any studies been conducted on such an eventuality and with what conclusions?

3. Which types of OPEC country investments would be the most disruptive and the least disruptive to U.S. financial markets, to the U.S. economy, and to U.S. national interests?

   In answering, please address the following points. Some observers believe that OPEC country equity investments and private debt placements are more in the interests of the United States and the international financial system, because they would "tie down" funds which could destabilize the system if they remained in liquid assets. Others believe that bank deposits and Government securities--though liquid--are preferable because (a) that type of investment is easier to observe, and (b) while it may confer on these OPEC countries some influence with the banks involved and with Treasury, it confers less control than equity investments. Still others favor OPEC country investments in long term bank deposits and Government securities. What is the Federal Reserve's view?

Stability of U.S. Banks Holding OPEC Surpluses

1. A November 20, 1974, FED paper by Sam Pizer, "Some Comments on the Petrodollar Problem" (remarks to a trade association), states on page 4:

   > Part of the problem with OPEC funds is the familiar one of reluctance by a few banks to become too dependent on such a narrow base of deposits. For their part, the OPEC countries probably have similar misgivings about placing too much with any single bank. Thus, the banks set limits on their exposure to OPEC funds, and some OPEC countries do likewise.

   a. How many banks have set limits on exposure to OPEC funds? How many banks receiving OPEC funds have not set such limits?

   b. Of those banks which do set limits, (1) describe the limits, (2) indicate the varying ranges of limits, and (3) for each range indicate the number of banks adhering thereto?

   c. Should the banks which do not set limits do so? If the answer is "yes," has the Federal Reserve encouraged them to do it?

2. You and others have expressed some concern about the stability of U.S. banks which have engaged in petrodollar recycling, lending these surpluses to LDCs. We require information about the Federal Reserve contingency plans for bank rescues in cases of substantial liquidity problems.

   a. At this time approximately how much would the Federal Reserve be willing to lend (1) to any one bank or (2) to all U.S. banks together during the period of one year, should such a crisis develop?

   b. You recently remarked that the number of U.S. banks with exposure in a single developing country, in excess of 30 percent of capital, jumped to 80 by year 1980 from only 36 in mid-1979. How many of these 80 banks have surpassed the U.S. bank regulatory voluntary country exposure lending limits?

   c. For this latter group of banks, how much assistance would the Federal Reserve have to extend if the LDC countries to which they lend defaulted *en masse* on their loans?

Confidentiality of OPEC Country-by-Country U.S. Investment Data

Federal Reserve Documents containing OPEC country data have contained the following caveat:

> STRICTLY CONFIDENTIAL--(TREASURY/F.R.)
>
> Note: The data of this section were compiled from Treasury Foreign Exchange Reports and from information supplied by the Foreign Operations Division of this Bank's Foreign Department. The Treasury may be extremely sensitive to these data being made available even to high officials of this Bank or to members of the Board of Governors since such access is not explicitly included in the existing access "agreement" with the Treasury. The Treasury is particularly sensitive to the release of data that are highly concentrated at one respondent, as are some of the figures in this report.

1. Has the access agreement between the Federal Reserve and the Treasury Department been modified or changed in any way? If so, how, and what were the reasons for the changes?

2. If the access agreement has not been modified to allow Board Governors and other high Federal Reserve officials access to this data, why not? Is Treasury or is the Federal Reserve responsible for the continuation of this limited access? If the latter, has the Board of Governors determined that this data should not be given to one or more of its members or to other high Federal Reserve officials?

Differences Between OPEC Foreign Exchange Holdings and Other Holdings

On July 2, 1981, the Federal Reserve furnished several updated tables. Table I shows OPEC governments holding $91.9 billion of reserves of foreign exchange, with Middle East OPEC countries holding $41.5 billion and African OPEC countries holding $12.2 billion. There is no accounting for the remaining $38.2 billion.

A table furnished to the subcommittee, by Treasury (attached), also on July 2, shows the following OPEC holdings: $99 billion in the Euro-banking market, $55 billion in other developed and nonmarket countries, $49.4 billion in the U.S., and so forth. It shows a total cumulative investible surplus of $318.75 billion, as of mid-1980. In the appendix to your testimony:

1. Explain how Middle East OPEC countries are deemed to hold only $41.5 billion in official reserves, while their investments in liquid assets are obviously substantially larger.

2. Also explain the $38.2 billion gap in the Federal Reserve's own figures.

Other Ways of Recycling Petrodollars

It has been reported that you believe that OPEC countries should now share some of the risks of recycling petrodollars. Briefly explain your plan where banks would act more as brokers than lenders. Has this plan been discussed with OPEC country leaders, and, if so, what was their reaction?

If you or your staff have any questions about your testimony, please contact Mr. McSpadden. We will need 75 copies of your testimony, 25 of which are required 24 hours before your appearance. Thank you for your cooperation

Sincerely,

Benjamin S. Rosenthal
Chairman

Enclosures

BSR:mb

Statistical Annex

OPEC Country Investible Surpluses

1. The Federal Reserve estimates of the OPEC current-account surplus, after taking account of public transfers, are as follows (in billions of dollars). We do not make estimates of individual country surpluses.

1974	70
1975	30
1976	37
1977	30
1978	0
1979	66
1980	103
Total, 1974-80	337

2.a. Below is a table on the "Estimated Deployment of OPEC Countries' Investible Surplus, 1974-80." Data for the years 1974-75 and 1979-80 are found in the 51st Annual Report for the BIS, June 15, 1981, p. 97; data for the other years, and revisions, were supplied specially by the BIS. "Short-term" means with a maturity of one year or less, "long-term" is all other.

	1974	1975	1976	1977	1978	1979	1980
	in billions of U.S. dollars						
Identified investible surplus 1/	53.2	35.2	35.8	33.5	13.4	60.6	86.5 r/
Short-term investments	36.6	9.5	9.8	11.9	3.1	43.2	42.5
of which:							
in the United States 2/	9.4	1.1	0.7	-0.5	-0.2	8.3	0.2
in the United Kingdom	18.2	3.4	3.0	3.2	-1.6	16.2	16.1
(of which: Eurocurrency deposits)	(13.8)	(4.1)	(5.6)	(3.1)	(-2.0)	(14.8)	(14.8)
in other industrial countries 3/	9.0	5.0	6.1	9.2	4.9	18.7	26.2
Long-term investments	16.6	25.7	26.0	21.6	10.3	17.4	44.0 r/
of which:							
in the United States	2.3	8.5	11.4	9.6	1.5	-1.5	14.3
in the United Kingdom	2.8	0.9	1.5	0.6	-0.2	1.0	1.5 r/
in other industrial countries	3.1	5.8	4.7	4.1	2.7	8.7	16.7
with international institutions 4/	3.5	4.0	2.0	0.3	0.1	-0.4	4.9
in developing countries	4.9	6.5	6.4	7.0	6.2	9.6	6.6

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1/ The difference between the current-account position and identified foreign investment reflects, apart from recording errors, borrowing (net of repayments) by OPEC countries, direct investment inflows, trade credits, and other unidentified capital flows.
2/ Includes bank deposits and money-market placements.
3/ Bank deposits only.
4/ IBRD and IMF.
r/ Revised since publication in BIS Report.
Source: Bank of England.

b. The Federal Reserve believes that on the whole the estimates of the disposition of the OPEC investible surpluses, presented above under 2.a., are the best available for its purposes. However, as regards the investments in the United States they do show some discrepancies with the U.S. Treasury's figures, perhaps because they have not picked up Treasury revisions of earlier data. Consequently the BIS estimates should be corrected for these discrepancies.

3.a. The Federal Reserve's own estimates of the OPEC current-account surpluses in the years 1974-80 aggregate about $337 billion, while the BIS estimates of the identified investments made in that period (corrected for discrepancies vis-a-vis U.S. Treasury figures on investments in the United States) cumulate to $313 billion. The difference of $24 billion reflects net unidentified investment flows. Of this total, $16 billion is applicable to 1980 and $8 billion to 1974-1979.

For individual years, it may be seen from the data shown above that the identified investments sometimes fall short of the estimated current surplus and sometimes (i.e., in 1975 and 1977-78) are greater than the current surplus. The numbers in the two series differ not only because of unidentified investment flows, but also because the amount of funds available to the OPEC countries for new investment during a particular year is affected by the amount of borrowing done by the OPEC countries in that year, by the amount of repayments of borrowings, and by foreign direct investment in OPEC countries, in addition to the current-account balance itself.

b. It is not the OPEC countries themselves that provide the information on the components of their investments, but rather the countries where the investments are made. With the recently improved reporting by industrial countries, it appears that the bulk of investments by OPEC countries are covered.

c. The $30 billion of unidentified capital inflows into the United States in 1980 do not seem to be associated in sizable degree with OPEC countries. Given that the recorded net inflows of OPEC funds were substantial, it seems likely that some unrecorded net inflows also came from OPEC countries. However, we do not believe that a substantial share of the unrecorded inflow is more likely to have been associated with OPEC investments than with non-OPEC investments.

4.a. The latest CIA estimates of the OPEC current-account surplus (including public transfers) in the years 1974-80, as communicated orally by CIA personnel to the Federal Reserve staff, compare with those of the Federal Reserve as follows (data in billions of dollars):

	1974	1975	1976	1977	1978	1979	1980
CIA	66	29	33	21	-3	60	103
Federal Reserve	70	31	37	30	0	66	103

b. The Federal Reserve has no information on how the CIA has made its estimates of the disposition of OPEC surpluses. The Federal Reserve estimates have been based largely or wholly on U.S. Treasury data (for investments in the United States) and Bank of England data. These sources have also been available to the CIA, which, however, has other sources of its own as well.

OPEC Country Holdings

1.a. On March 31, 1981, foreign branches of U.S. banks had total liabilities of $408.4 billion, of which $29.3 billion were to OPEC countries. The breakdown of the liabilities to OPEC was as follows (in billions of dollars):

Ecuador	0.3
Venezuela	3.6
Indonesia	1.5
Middle East countries	20.7
African countries	3.2
Total	29.3

b. The $29.3 billion of liabilities to OPEC compares with $379.1 billion to other countries.

c. The data collected from the foreign branches do not contain a breakdown between demand and time deposits. In the Eurocurrency market, deposits have maturities ranging from overnight to as long as several years. At the end of 1980 the maturity breakdown, in percentages of the total, of dollar deposits at foreign branches of U.S. banks was as follows:

Less than 3 days	- 21 percent
3 days to 1 month	- 31 percent
Over 1 month to 3 months	- 26 percent
Over 3 months to 6 months	- 16 percent
Over 6 months to 1 year	- 4 percent
Over 1 year	- 2 percent

The distribution of OPEC deposits at the foreign branches was probably very similar to that for total deposits.

d. The information referred to was sent to Chairman Rosenthal by letter (from Chairman Volcker) dated July 10. The liabilities to Middle East oil-exporting countries of the domestic offices and foreign branches of three groups of U.S. banks were as follows (in billions of dollars):

	3/31/79	3/31/81
Six largest U.S. banks	19.4	19.8
Second largest six	2.1	3.0
Next nine banks	0.8	1.2

2. The very small increase of only $0.9 billion in 1980 in OPEC holdings in foreign branches of U.S. banks, compared with an increase of $9.1 billion in 1979, mainly reflects actions involving depositors in Middle

East OPEC countries. Foreign branch liabilities to Middle East oil-exporting countries rose $5.3 billion in 1979, but declined $1.1 billion in 1980. In addition to the well-known special factors affecting foreign branch liabilities to Iran, some Middle East oil-exporting countries evidently became less inclined during 1980 to hold funds in U.S.-chartered banks. (On the other hand, Middle East holdings of U.S. Government and other U.S. securities increased in 1980.) The evidence suggests that total bank deposits held by Middle East oil-exporting countries increased as much or more in 1980 as in 1979, and that the flow of funds formerly going into foreign branches of U.S. banks was diverted to non-U.S. banks.

The $0.8 billion decline in the first quarter of 1980 resulted from declines in liabilities to Venezuela and Middle East oil-exporting countries (partly offset by increases in liabilities to Indonesia and African oil-exporting countries). We are not aware of any special factors producing these results, but would point out that temporary fluctuations in accounts may be a factor in any short period.

3. Table 1 which the Federal Reserve sent on July 1 contains only data on holdings that are classified as official. As of December 1980, official OPEC holdings of banking and money market assets in the United States totaled $6.6 billion. The Treasury data furnished the Subcommittee include holdings of commercial banks (government- or privately-owned) and of nonbanks, including government-owned as well as privately-owned commercial enterprises.

4. The Federal Reserve does not have information that would allow it to calculate with precision the interest paid to OPEC countries on their deposits in foreign branches of U.S. banks in the years 1974-80, particularly given that no data were collected before December 1975 on the geographical breakdown of branch liabilities. For the years 1976-80, a rough estimate could be made by estimating the average amount of deposits outstanding in each

year (by averaging the quarter-end figures) and using the annual average 3-month Eurodollar rate as being typical of the interest rates paid on the deposits during the year. This approximative method yields the following results:

	Average Deposits Outstanding ($ billions)	Average Interest Rate (% p.a.)	Interest Paid ($ billion)
1976	16.2	5.6	0.9
1977	19.4	6.0	1.2
1978	20.2	8.7	1.8
1979	26.1	12.0	3.1
1980	30.2	14.0	4.2

OPEC Country Investment Trends and Strategies

The following response to your question regarding the status of the interagency technical group on international flows of funds has been prepared by the Treasury Department:

This group was a technical one, charged with monitoring international flows of funds arising from the accumulation and disposition of large payments surpluses by the OPEC countries. Its mandate was limited to the collection of information, excluding either analysis or policy recommendations. It was chaired by a Treasury technician, with participation by technical representatives from the State Department, Federal Reserve Board, Council of Economic Advisors, and Central Intelligence Agency, plus the Federal Reserve Bank of New York and the Commerce Department. Its main functions were to identify and evaluate technically all available sources and types of ongoing statistical information on this subject from various U.S. Government agencies, international organizations, and other sources, and to share technical information and methods for estimating other aspects of the subject for which direct statistics were inherently unavailable. These were basically one-time tasks and they were substantially completed by the end of 1975, after which the group ceased to function except as a channel for exchange of current data and for ad hoc bilateral consultations among the participants.

Adequacy of the Federal Reserve's Data Collection Efforts

1.a. The Federal Reserve's quarterly reports from the foreign branches of U.S. banks, showing the country by country breakdown of their foreign assets, collect information on total assets and total liabilities vis-a-vis each country. Detailed reports on the type of customer or the currency of the claim or liability for each of the 165 countries included in the report would represent an excessive reporting burden on the banks.

b. The branch reporting system has in fact worked well in our view, and we have no significant difficulties or problems with it.

2. An interagency committee has conducted an inquiry to identify transactions which may not have been properly reported, and reporting instructions are being revised to ensure that these transactions are properly reported. As the agent for the Treasury, the Federal Reserve Bank of New York will assist in overseeing implementation of the revised procedures.

Confidentiality of OPEC Country-by-Country U.S. Investment Data

The statement of confidentiality contained in certain documents of the Federal Reserve Bank of New York for a short period pending conclusion of a final access agreement was designed to alert the selected staff members at that Bank who received such documents to the sensitivity of the data. The statement was not intended to prevent disclosure of the information to the Chairman or other Board Members when needed in connection with official responsibilities. Information on individual accounts has not been distributed routinely to Board Members. However, the Board is kept informed of developments regarding OPEC investments through periodic reports concerning this group of countries.

Differences Between OPEC Foreign Exchange Holdings and Other Holdings

1. The data in Table 1 (submitted by letter of July 1, 1981) relating to official holdings of foreign exchange are not Federal Reserve data; instead they are taken from the International Monetary Fund publication, International Financial Statistics. There are several reasons why the official foreign exchange holdings of the Middle East oil-exporting countries in March 1981, as shown in that IMF publication, are much smaller than the accumulated foreign assets of those countries. First, not all the foreign assets acquired by holders in those countries are held by official institutions. Second, official holdings include assets other than foreign exchange, e.g., gold, SDRs, and the country's IMF position. Third, some countries do not include in the "foreign exchange" holdings they report to the IMF, assets that are relatively illiquid, e.g., loans to other governments, equities, and certain other securities. Fourth, as noted in footnote 1 to the table, Saudi Arabia excludes foreign exchange cover against the note issue from the holdings it reports to the IMF. Fifth, as also noted in footnote 1, the data since December 1978 exclude entirely the official foreign exchange holdings of several Middle East countries, as from various dates. The holdings of Iran, Iraq, Kuwait and Qatar are all excluded from the Middle East data on line I.A.1. for March, 1981.

2. The $38.2 billion "gap" reflects the fact that, whereas International Financial Statistics does not show the official foreign exchange holdings of many individual oil-exporting countries, estimates of those "missing" holdings are made by the IMF staff so that the publication can show a figure for official foreign exchange holdings of all oil-exporting countries as a group.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

July 1, 1981

PAUL A. VOLCKER
CHAIRMAN

RECEIVED
JUL 2 1981
COMMERCE, CONSUMER AND
MONETARY AFFAIRS SUBCOMMITTEE

The Honorable Benjamin S. Rosenthal
Chairman
Subcommittee on Commerce, Consumer
and Monetary Affairs
Committee on Government Operations
House of Representatives
Washington, D.C. 20515

Dear Chairman Rosenthal:

In your letter of June 16, you asked that the Federal Reserve update several tables on OPEC holdings, reserves, and deposits that were furnished to your Subcommittee in July 1979. You also requested an update of the information contained in Governor Coldwell's letter to you of August 21, 1979.

The four updated tables are enclosed. We encountered an unexpected delay in obtaining the information needed to update Governor Coldwell's letter, but we will be able to send you those figures within a few days.

Sincerely,

Paul A. Volcker

Enclosures

TABLE 1

FOREIGN OFFICIAL RESERVES OF FOREIGN EXCHANGE
(billions of dollars)

	December 1970	1973	1977	1978	1979	1980	Mar. 1981
I. Total Holdings	45.4	122.4	243.0	283.3	318.6	382.4	371.5
A. OPEC countries	3.6	12.6	67.9	53.0 1/	65.9 1/	87.4 1/	91.9 1/
1. Middle Eastern 2/	2.5	8.5	52.4	41.7 1/	41.9 1/	40.8 1/	41.4 1/
2. Africa 3/	0.3	1.3	5.3	3.2	7.4	13.4	12.2
3. Other 4/	0.7	2.6	9.6	8.1	10.7	11.8	n.a.
B. All other countries	41.8	109.8	175.1	230.3	252.7	295.0	279.6
II. Holdings in the United States	23.8	66.9	131.1	162.4	162.0	177.0	182.2
A. Treasury bills and certificates	13.4	31.5	47.8	67.7	47.8	56.5	60.6
1. OPEC countries 5/	n.a.	n.a.	4.2	3.3	6.6	8.0	8.2
2. Other countries	n.a.	n.a.	43.6	64.4	41.2	48.5	52.4
B. Marketable Treasury bonds and notes	0.3	5.7	32.2	35.9	43.0	46.0	49.7
1. OPEC countries 5/ (approximate)	n.a.	n.a.	11.0	9.0	8.2	16.3	19.3
2. Other countries	n.a.	n.a.	21.2	26.9	34.8	29.7	30.4
C. Nonmarketable Treasury bonds and notes 6/	3.4	15.5	20.4	21.0	22.7	21.1	20.7
D. Other U.S. securities	0.7	1.7	12.7	14.7	15.7	21.0 e/	22.3 e/
E. Banking and money market assets 7/	5.9	12.4	18.0	23.1	32.8	32.4	28.9
1. OPEC countries	n.a.	n.a.	9.6	10.2	8.6	6.6	7.6
2. Other countries	n.a.	n.a.	8.4	12.8	24.2	25.8	21.3
III. Holdings at Foreign Branches of U.S. Banks	4.2	10.3	28.1	31.9	35.7	32.4	29.9
A. OPEC countries 5/8/	n.a.	n.a.	19.1	20.1	29.2	30.1	29.3
B. Other countries	n.a.	n.a.	9.0	11.8	6.5	2.3	.6

1/ Beginning April 1978 data exclude Saudi Arabian foreign exchange cover against the note issue (amounting to about $5.3 billion in March 1978). The figures on the line for "Middle Eastern countries" also exclude Iraq (beginning December 1978), Iran and Qatar (beginning December 1980), and Kuwait (for March 1981). However, estimates for these countries and dates are included in the figures for "OPEC countries."
2/ Iran, Iraq, Kuwait, Libya, Qatar, Saudi Arabia, United Arab Emirates.
3/ Algeria, Gabon, Nigeria.
4/ Ecuador, Venezuela, Indonesia.
5/ Also includes Bahrain and Oman.
6/ None held by OPEC.
7/ Principally bank deposits, CDs, repurchase agreements, bankers acceptances, and commercial paper.
8/ Including some private holdings.
e/ Estimated from Treasury and Commerce Department data.

Sources I.: International Monetary Fund, International Financial Statistics.
II.: U.S. Treasury.
III.: Federal Reserve System.

TABLE 2

FOREIGN OFFICIAL HOLDINGS OF MARKETABLE U.S. TREASURY SECURITIES, SELECTED DATES

	Amount ($ billions)			Percentage of total outstanding		
	Bills	Bonds & Notes	Total	Bills	Bonds & Notes	Total
1968 - November	6.5	.5	7.0	8.9	0.3	3.0
1969 - June	3.8	.5	4.3	5.6	0.3	1.9
1973 - March	37.6	6.9	44.5	35.8	4.2	16.5
1974 - January	29.2	5.2	34.4	27.1	3.2	12.7
1979 - January	68.4	36.0	104.4	42.1	10.8	21.0
- April	51.3	36.3	87.6	31.3	10.7	17.4
1980 - January	49.0	44.1	93.1	27.9	12.2	17.4
1981 - January	56.6	46.8	103.4	25.7	11.5	16.5

TABLE 3

DEPOSITS OF MIDDLE EAST OIL PRODUCING COUNTRIES
IN FOREIGN BRANCHES OF LARGE U.S. BANKS
(billions of dollars)

	December 1975			March 1979			March 1981		
	Six Largest Banks	Second Largest Six Banks	Next Nine Banks	Six Largest Banks	Second Largest Six Banks	Next Nine Banks	Six Largest Banks	Second Largest Six Banks	Next Nine Banks
(1) Total deposits (consolidated)	197.5	76.3	49.9	273.8 1/	99.9 1/	68.4 1/	328.5	126.5	85.2
(2) Deposits of Middle East Oil Producing Countries 2/	9.8	1.2	0.7	15.3	1.7	0.5	14.8	2.7	0.9
(3) Line (2) as percent of line (1)	5.0	1.6	1.4	6.0	1.7	0.7	4.5	2.1	1.0

Note: Deposits in foreign branches represent more than 75 percent of total deposits of Middle East oil producers in all U.S. banks.

1/ Deposits as of Dec. 1978.
2/ Includes Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

Six largest banks

Bank of America
Chase Manhattan
Chemical Bank
Citibank
Manufacturers Hanover
Morgan Guaranty

Second largest

Bankers Trust
Continental Illinois
Crocker National Bank
First National Bank of Chicago
Security Pacific
Wells Fargo

Next nine

European American Bank & Trust
First National Bank of Boston
First National Bank of Dallas
First National Bank of Detroit
Irving Trust
Marine Midland
Mellon
Republic National Bank, Dallas
United California Bank

TABLE 4

NUMBER OF U.S.-CHARTERED BANKS REPORTING LIABILITIES TO OPEC COUNTRIES AT FOREIGN BRANCHES

	Dec. 1975	Dec. 1976	Dec. 1977	Dec. 1978	Dec. 1979	Dec. 1980
Ecuador	31	36	46	45	45	60
Venezuela	80	82	89	81	88	92
Indonesia	48	52	50	43	39	36
Iran	40	50	53	50	43	41
Iraq	11	23	24	13	14	14
Kuwait	28	30	33	29	34	33
Qatar	17	8	15	17	16	9
Saudi Arabia	18	30	31	33	40	43
United Arab Emirates	19	24	34	38	40	27
Algeria	36	44	45	51	54	54
Gabon	16	19	26	19	20	17
Libya	9	15	14	12	13	11
Nigeria	11	14	13	19	23	26

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JUL 17 1981
MONETARY AFFAIRS SUBCOMMITTEE

PAUL A. VOLCKER
CHAIRMAN

July 10, 1981

CONGRESSMAN BEN ROSENTHAL
STAFF
PARA:
COMMENTS:
FILE CODE:

The Honorable Benjamin S. Rosenthal
Chairman
Subcommittee on Commerce, Consumer
and Monetary Affairs
Committee on Government Operations
House of Representatives
Washington, D. C. 20515

Dear Chairman Rosenthal:

Following up my letter of July 1, I am herewith transmitting to you the data on the liabilities to Middle East oil-exporting countries of both the domestic offices and the foreign branches of three groups of large U. S. banks. The latest data, which are for March 31, 1981, are shown below, together with the earlier data for March 31, 1979, that were transmitted to you by Governor Coldwell in August 1979. The figures are as follows (in billions of dollars):

	3/31/79	3/31/81
Six largest U. S. banks	19.4	19.8
Second largest six	2.1	3.0
Next nine banks	0.8	1.2

The information on the liabilities of the domestic offices has been supplied by the U. S. Treasury and include the liabilities of all Edge Act and other domestic subsidiaries as well as those of the parent bank itself.

Sincerely,

Paul A Volcker

Mr. ROSENTHAL. Several final matters. I am inserting into the record, first, a letter and material from the Secretary of Commerce relating to OPEC direct investments in the United States; second, an excerpt from a 1980 Government Operations Committee report commenting on the accuracy of Commerce's OPEC direct investment statistics; and third, several news clippings which subcommittee members referred to during yesterday's hearings.

The subcommittee stands adjourned.

[The material referred to follows:]

THE SECRETARY OF COMMERCE
Washington, D.C. 20230

July 8, 1981

Honorable Benjamin S. Rosenthal
Chairman, Subcommittee on Commerce,
Consumer and Monetary Affairs
Committee on Government Operations
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Thank you for your letter concerning OPEC foreign investment in the United States and the "Balance of Payments Statistical Discrepancy."

The information you requested about such investment and the discrepancy is contained in the attached tables and reports which are as follows:

1. Table one lists the number of U.S. Affiliates whose parent companies are located in an OPEC country.
2. Table two describes the OPEC Direct Investment Position in the United States.
3. A list of OPEC Direct Investments in the United States from 1974 to the end of 1979. This report was prepared by the Office of International Investment (formerly the Office of Foreign Investment in the United States (OFIUS)) of the International Trade Administration (ITA).
4. A status report on the Balance of Payments Statistical Discrepancy together with the June 1981 "Progress Report" on that same subject.

The report on OPEC Direct Investments from 1974-1979 prepared by ITA contains revisions to the data furnished to your Subcommittee on July 19, 1979. This report is updated through December of 1980. Data as to OPEC investments for 1980 and the first half of 1981 are currently being compiled and verified and will be provided to you in advance of your Subcommittee's hearings later this month.

If I can be of any further assistance, please let me know.

Sincerely,

Malcolm Baldrige

Secretary of Commerce

[SUBCOMMITTEE NOTE: The status report referred to in item 4 is found in appendix 3c.]

Table 1.--Number of U.S. Affiliates Whose Parents are Located in a Member Country of OPEC, As of the End of 1980, by BEA Industry 1/

Industry Title	BEA Industry Code	Total	Ecuador	Venezuela	Gabon	Libya	Iran	Kuwait	Saudi Arabia	United Arab Emirates	Indonesia
Agriculture:											
Agric. prod.-crops	010	6		5				1			
Agric. prod.-livestock, except beef cattle feedlots	020	4		2		1		1			
Agric. prod.-beef cattle feedlots	021	1						1			
Agric. services	070	1		1							
Petroleum:											
Crude petro. extraction (no refining) and natural gas	133	2		1					1		
Oil and gas field services	138	1						1			
Petro. refining without extraction	292	1							1		
Construction	150	1	1								
Manufacturing:											
Dairy products	202	1							1		
Bakery products	205	1		1							
Other food and kindred products	209	1		1							
Miscellaneous converted paper products	264	1		1							
Miscellaneous plastics products	307	1							1		
Fabricated structural metal products	344	1							1		
Transportation:											
Other water transportation	449	1					1				
Wholesale Trade:											
Machinery, equip. and supplies, except farm and garden machinery and equipment	508	5		2			1		1		1
Miscellaneous durable goods, n.e.c	509	1		1							
Drugs, proprietaries, and sundries	512	1					1				
Apparel, piece goods, and notions	513	1								1	
Groceries and related products	514	1			1						
Farm-product raw materials	515	2		1							1
Petroleum and petroleum products	517	3		2				1			
Miscellaneous nondurable goods, n.e.c	519	1		1							
Retail Trade:											
Food stores and eating and drinking places	540	1									1
Retail trade, except gasoline service stations, food stores and eating and drinking places	590	3					2		1		
Finance, Insurance, and Real Estate:											
Banking	600	13	1	4			3		4	1	
Credit agencies other than banks	610	4		2				1	1		
Insurance carriers, agents, brokers, and services	630	1		1							
Lessors of gasoline service stations and sites	640	1		1							
Real estate	650	101	16	47		1	9	19	6	1	2
Hotels and other lodging places	700	1								1	
Services:											
Other personal and business services, n.e.c., provided on a commercial basis	899	8		4				1	3		
		172	18	78	1	2	17	26	21	4	5

Addendum:
Cost of investments, 1979 and 1980 .... $178 million
Value of assets purchased, 1979 and 1980 .... $571 million

1. The following members of OPEC do not have any U.S. affiliates: Algeria, Nigeria, Iraq, and Qatar.

Table 2.--Direct Investment Position in the United States at End of Period, 1973-1980[p]

(Millions of dollars)

	1973	1974	1975	1976	1977	1978[r]	1979[r]	1980[p]
Ecuador	3	5	2	6	7	5	7	10
Venezuela	42	74	41	36	50	46	37	29
Latin America	45	78	42	42	56	51	44	39
Algeria	0	0	0	0	0	(*)	(*)	(*)
Gabon	-2	1	1	1	1	1	1	1
Libya	0	0	0	0	0	0	(*)	(*)
Nigeria 1/	(*)	-1	-1	9	(*)	16	27	18
Africa	-2	(*)	-1	10	(*)	17	27	19
Iran	6	4	4	4	4	5	3	4
Iraq	0	0	0	0	0	0	0	0
Kuwait	37	(D)	(D)	100	172	257	279	299
Qatar 1/	1	2	4	2	1	1	(*)	(D)
Saudi Arabia	5	(D)	(D)	10	(D)	(D)	(D)	200
U. Arab Emirates ...	0	0	0	0	(D)	(D)	(D)	(D)
Middle East.......	48	125	131	116	204	305	321	520
Indonesia = Pacific.	(*)	-1	-3	-4	-5	-6	-7	-2
OPEC Total	92	201	169	163	256	366	385	576
MEMO: Arab OPEC	42	121	127	112	200	300	318	515

p Preliminary. (Preliminary data for 1980 have not yet been published; they will first appear in the August 1981 issue of the Survey of Current Business.)

r Revised. (Revised data for 1979 have not yet been published; they will first appear in the August 1981 issue of the Survey of Current Business.)

* Less than $500,000 plus or minus.

D Suppressed to avoid disclosure of data of individual companies.

1. Even though Nigeria and Qatar do not have any U.S. affiliates, a direct investment position is shown for them which reflects transactions between a U.S. affiliate and a foreign affiliate, of the foreign parent, located in one of these countries.

OPEC DIRECT INVESTMENT IN THE UNITED STATES

Investment Analysis Division
Office of International Investment
International Trade Administration
U.S. Department of Commerce
September 1981

DRAFT

Preface

This publication has been developed by the International Trade Administration's Office of International Investment (formerly the Office of Foreign Investment in the United States) as part of its ongoing monitoring and public information program.

The core of this annual report is a listing of OPEC investments arranged on a country-by-country basis. The listing also includes information on the location of the investment, the U.S. industry, the foreign corporate owner, the foreign beneficial owner, the type of investment, and the value of the transaction where available. The transactions listed here are representative of the types of OPEC direct investment in the United States. However, the list is not a list of total OPEC direct investments since it includes only those transactions identified in public source documents.

This report was prepared by Michael A. Goodwin, an international economist, in the Investment Analysis Division. The Office of International Investment welcomes inquiries or comments on this report. They should be addressed to:

Office of International Investment
International Trade Administration
U.S. Department of Commerce
Washington, D.C. 20230

OPEC DIRECT INVESTMENT IN THE UNITED STATES

Although several OPEC countries[1/] began diversifying their investment portfolio by placing larger amounts of their surplus oil revenues in West German and Japanese investments in 1980, the amount of OPEC direct investment in the United States rose significantly last year. The following presentation discusses 1980 and January-June 1981 OPEC direct investment activity in the United States and includes a listing of transactions for this period. A listing of OPEC transactions for 1974-1979, which has been issued in previous annual reports, is attached as an appendix for reference purposes.

Transaction Figures

The number of 1980 OPEC direct investments identified by the Office of International Investment (OII) declined about six percent from the 1979 total, but the dollar figure rose almost 63 percent. Of the 34 cases of OPEC direct investment in the United States, 20 had values totaling $570.9 million in 1980. Thirty transactions were completed, and 18 of these had values totaling $169.4 million. There were four pending cases, two of which had values totaling $401.5 million. Most of the total for pending cases ($400 million) was accounted for by the Coastal and Offshore Plant Systems transaction, a proposed North Carolina aluminum smelter, which was the largest single OPEC transaction value recorded in 1980.[2/]

1/ The OPEC countries are Algeria, Ecuador, Gabon, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates and Venezuela.

2/ See page 8 for subsequent developments in this case.

These 34 OPEC transactions represent 2.2 percent of the 1,550 (est.) foreign direct investments identified by OII in 1980. The $570.9 million total value of OPEC transactions is less than one percent of the $20 billion (est.) total value of all recorded direct investments for last year. OPEC transactions accounted for 2.8 percent of the 1980 total of 1,199 completed transactions, and the value of 18 completed transactions ($169.4 million) was also less than 1 percent of the $14.8 billion value of transactions completed in 1980.[3/]

Source Country, Industrial and Geographic Distribution

Saudi Arabia with 23 transactions and Kuwait with 5 accounted for 82 percent of the OPEC transactions. Thirteen of the Saudi Arabian transactions had a total value of $512.8 million and three of the Kuwaiti transactions totaled $47.6 million. Together these two countries accounted for 98 percent of the total 1980 OPEC values.

The largest completed transaction was a $40 million bank acquisition. The Patagonia Corp. of Tucson, Arizona sold its commercial banking subsidiary, Great Western Bank & Trust Company of Phoenix, to the GWB Holding Co., a corporation formed in Delaware by a group of four Kuwaiti businessmen. The purchasers are Khalid Abdulmohsin Al-Babtain,

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3/ The relatively small proportion of total 1980 inward foreign direct investments accounted for by OPEC investors is similar to Bureau of Economic Analysis data indicating that the cumulative value of OPEC direct investment in the United States accounts for less than 1 percent of total inward foreign direct investment from all sources.

Salah Fahd Sultan, Adnan Al-Sane, and Abdulaziz Saud Al-Babtain. Great Western Bank & Trust is the fifth largest commercial bank in Arizona, with 34 branches through the state.

Acquisitions were the most frequent type of OPEC investment and accounted for 14 transactions. The other most frequently recorded investments were equity increases (five), and the establishment of new offices (four).

OPEC investors were most active in the real estate and banking sectors in 1980. There were eight real estate transactions recorded; all of them were complete, and five had a total value of $74.6 million. Six transactions were acquisitions; one, a construction project; and one, a new subsidiary. The most prominent individual investor in this sector is Abdul Latif Jameel, a Saudi Arabian businessman who invested $67 million in three real estate projects in 1980 -- the acquisition of CNA Tower in Orlando, Florida, the acquisition of the Life of Georgia Tower in Atlanta, and the construction of an office development project in Orlando. Jameel Holdings (Bermuda) Ltd. handles the investments of the Jameel family.

Four OPEC banking transactions were recorded in 1980, three complete and one pending. Two values for completed transactions totaled $47 million. Patagonia Corp.'s Great Western Bank & Trust Co. of Phoenix accounted for $40 million, and Ghaith Pharaon completed his acquisition of the National Bank of Georgia at a cost of $7 million for the remaining shares outstanding.

Fifty percent of the OPEC investments were located in three states and the District of Columbia. Texas had six transactions, Florida, five transactions, and New York and the District of Columbia each listed three transactions.

Major Developments

Several OPEC transactions were significant in 1980. In the banking sector, the group of Middle Eastern investors who have been trying for three years to acquire Financial General Bankshares, Inc., against considerable opposition, moved closer to their goal last year. The Washington-based bank holding company agreed to an offer of $28.50 per share or a total of $148 million from the group, which already owns an 18.5 percent interest.

Financial General also agreed to add three members to its board to represent the group. However, no tender offer can take place until the Federal Reserve Board and several state regulatory agencies review the prospective change in control. Since Financial General's Bank of Maryland subsidiary has approved the filing of an acquisition application with the Maryland Bank Regulations Board, a major obstacle has been removed.

In another banking development, a Federal Appeals Court overturned the Federal Reserve Board's ruling that Adnan Khashoggi could not convert the Security National Bank of Walnut Creek, California into a holding company. Khashoggi, a Saudi Arabian businessman, bought the bank in 1973.

In July 1980, First Arabian Corp., a Paris-based group of Middle Eastern investors led by Roger Tamraz, offered $16.8 million or $6 per share for the 2.8 million common shares outstanding of Northern States Bancorporation, a Detroit-based multibank holding company. First Arabian investors planned to merge City National Bank of Detroit, the holding company's main bank, with Bank of the Commonwealth, a Detroit bank that is 77 percent owned by First Arabian. However, Northern States rejected the acquisition proposal.

OPEC interest in the U.S. petroleum industry also was evident in 1980. The government of Kuwait offered to buy the J. Paul Getty estate's 14.6 percent holding of the common stock of Getty Oil Co. for $982 million. Getty Oil opposed the bid on the ground that the block of stock should be more widely distributed. Subsequently, the estate's executors unanimously decided to reject the Kuwaiti offer.

Preliminary 1981 Transaction Figures

In the first half of 1981, OII identified 12 OPEC direct investment transactions in the United States. Seven transactions had a total value of $318.3 million. Six transactions were complete; three had values totaling $15.3 million. Six transactions were pending; four of these had a total value of $303 million.

Almost 42 percent of the OPEC transactions during this period were in the petroleum sector. One transaction is in the oil/gas exploration and development area, and four are petroleum refining transactions.

The largest petroleum industry investment, which is also the largest investment identified during the first half of 1981, is the Pacific Resources Inc.-Kuwait Petroleum Corp. joint venture. Pacific Resources, a Honolulu-based energy firm, and Kuwait Petroleum, the government-owned oil company signed a preliminary agreement in May 1981 that calls for Pacific Resources to transfer ownership of its only refinery, Hawaiian Independent Refinery Inc., to the joint venture and to assume all management responsibilities. Kuwait Petroleum will contribute $185 million in cash and guarantee 50 percent of the joint venture's crude oil supply requirements. The joint venture will be owned equally by the two companies that will have equal representation on the board of directors.

Kuwait Petroleum has also announced the formation of a 50-50 joint venture with AZL Resources Inc., an Arizona-based agribusiness and natural resources company. The joint venture will explore for oil, natural gas and minerals in the United States. The venture will be capitalized initially with $100 million contributed equally by AZL and Kuwait Petroleum. Added capital may be raised by mutual agreement for the 5-year joint venture, which can be extended by mutual consent. The venture will be managed by Solar Petroleum Inc., an AZL subsidiary.

AZL has three major foreign shareholders. Maurice Strong, a Canadian businessman and chairman of AZL Resources, is the company's largest shareholder. Strong, together with Paul Nathanson, another Canadian businessman, controls 36.3 percent of AZL's common shares through Stronat International Ltd., a Bermuda holding company, and Stronat Investments Ltd., a Canadian holding company. The third foreign shareholder is Adnan Khashoggi who acquired 15.3 percent of AZL's common shares in April 1974.

In March 1981, Black Creek NV purchased Uni International Corp., a Houston, Texas privately held bankrupt oil refinery, from the Hajecate group. The purchase price was not disclosed. Black Creek NV is incorporated in the Netherlands Antilles by a group of unidentified Middle Eastern investors, reportedly from Kuwait and Saudi Arabia, which was formed by Peter de Savary, a London businessman.

A second group of unidentified Middle Eastern investors, formed by Peter de Savary, purchased Independent Refining Corp.'s refinery at Winnie, Texas and its subsidiary's (Erickson Refining) plant at Port Neches, Texas. The value of the transaction was not disclosed. De Savary is now chairman and chief executive officer of Independent Refining.

The final transaction in the petroleum refining industry is a transfer of assets between foreign parent companies. American Petrofina Inc. has signed a letter of intent to sell its Port Arthur, Texas refinery and petrochemical and terminal facilities to American International Petroleum Corp. American International is a Houston-based joint venture. The venture was formed by Sociedad Financiera Credival C.A. of Caracas, Venezuela and Transatlantic Energy A.G. of Switzerland to own and operate the refinery.

Cancellation of Major 1980 Investment

During the first quarter of 1981, the Coastal and Offshore Plant Systems transaction, at $400 million the largest 1980 pending transaction from the OPEC countries, was cancelled. U.S. backers of the proposed North Carolina aluminum smelting and refining plant project were unable to secure the necessary financing commitments.

As a result of the cancellation of this transaction, the 1980 figures have been revised downward substantially. Thirty-three OPEC investments had 20 values totaling $170.9 million. Completed transaction figures remained the same; however, the number and value of pending transactions changed. Three pending investments indicated one value of $1.5 million.

While OPEC direct investment in the United States continues to rise, it still represents only a modest percentage of total foreign direct investment here. In 1980, OPEC investment was again concentrated in the banking and real estate sectors, while investment in the manufacturing sectors was often in companies providing development products and services for export back home. Preliminary 1981 OII investment data indicate increased OPEC investor interest in the U.S. petroleum industry.

In the 1980s, OPEC direct investment continues to be a small part of the total foreign investment picture in the United States. Furthermore, OII's monitoring program finds that OPEC investors have begun to diversify their investments to Europe and Southeast Asia. Nevertheless, the United States continues to attract OPEC investors who, like other foreign investors, are drawn by the sheer size and stability of the market and the knowledge that investment here spreads both the opportunities and the risks.

1980 OPEC DIRECT INVESTMENT IN THE UNITED STATES

SOURCE COUNTRY	US COMPANY	STATE	US INDUSTRY	FOREIGN OWNER	INDUSTRY OF FOREIGN OWNER	FOREIGN BENEFICIAL OWNER	COST OF TRANSACTION $ MILLIONS	TYPE OF TRANSACTION	STATUS OF TRANSACTION
Iran	Banca Serfin Agency	NY	60 Banking	Banca Serfin SA	60 Banking		NA	NAG	C
	Vicks Auto Parts Inc.	OR	50 Wholesale Auto Parts			Unidentified Investor	NA	ACQ (100%)	C
Kuwait	Office Building	VA	65 Real Estate			K. Al-Ghanem	6.5	ACQ (100%)	C
	Patagonia Corp.'s Great Western Bank & Trust Co. of Phoenix	AZ	60 Banking			K.A.M. Al Babtain et al	40.0	ACQ (100%)	C
	Petra Florida Corp.	FL	65 Real Estate Development	Kuwait Financial Center et al	67 Holding Co.	A. Al-Sabah et al	NA	NS (42.5%)	C
	Retail Property (59,000 sq. ft.)	FL	65 Real Estate	Kuwait Financial Center	67 Holding Co.	A. Al-Sabah et al	1.1	ACQ (100%)	C
	United Petra Ltd.	UNK	62 Investment Service	Kuwait Financial Center	67 Holding Co.	A. Al-Sabah et al	NA	JV	C
Libya	Calvary Church of the Nazarene	VA	89 Religious Organization			Government of Libya	1.5	ACQ (100%)	P

2.

1980 /

SOURCE COMPANY	US COMPANY	STATE	US INDUSTRY	FOREIGN OWNER	INDUSTRY OF FOREIGN OWNER	FOREIGN BENEFICIAL OWNER	COST OF TRANSACTION $,MILLION	TYPE OF TRANSACTION	STATUS OF TRANSACTION
Saudi Arabia	Aircraft Management Associates (Enstrom Helicopter Co.)	MI	67 Holding Co.	Bravo Investments BV (The Netherlands)	67 Holding Co.	Unidentified Group of Investors	NA	ACQ (100%)	C
	Air Monitoring	MI	73 Computer Services	Olayan Investment Co. (Liechenstein)	67 Holding Co.	S. Olayan	NA	ACQ (16.1%)	C
	Al-Madinah	DC	27 Newspaper Publishing	Al-Madinah	27 Newspaper Publishing		NA	NOF	C
	CNA Tower	FL	65 Real Estate			A. Jameel	17.0	ACQ (100%)	C
	Coastal and Offshore Plant Systems	NC	34 Aluminum Smelting			Unidentified Investors	400.0	NP	P
	CRS Group Inc.	TX	89 Construction Mgmt.	GRP Investments NV (N. Ant.)	67 Investment Holding Co.	G. Pharaon	0.3	EI (20% to 20.6%)	C
	Donaldson, Lufkin & Jenrette, Inc.	NY	62 Brokerage	Competrol Establishment (Liech.)	67 Holding Co.	K. Al-Saud S. Olayan	9.2	EI (11.1% to 11.5%)	C
	Eden Roc Hotel	FL	70 Hotels	Tarek Wadji Investments NV (Neth. Antilles)	67 Holding Co.	W. Tahlawi	12.5	ACQ (100%)	C

3.

1980

SOURCE COUNTRY	US COMPANY	STATE	US INDUSTRY	FOREIGN OWNER	INDUSTRY OF FOREIGN OWNER	FOREIGN BENEFICIAL OWNER	COST OF TRANSACTION $ MILLIONS	TYPE OF TRANSACTION	STATUS TRANSACTION
Saudi Arabia	Fashion Two Twenty Inc.	OH	28 Cosmetics			H.M. Alamoudi	2.0	ACQ (36.7%)	C
	Hyatt International Corp.	IL	70 Hotels	GRP Investments NV		G. Pharaon	1.5	EI (21.4% to 29%)*	C
	KAL Enterprises Inc.	DC	15 Construction	National Development Co. (NADCO)	15 Construction		NA	NOF	C
	Land for Residential Development (Wilshire Blvd.)	CA	65 Real Estate			H. Sarkis	NA	ACQ (100%)	C
	Life of Georgia Tower	GA	65 Real Estate	Jameel Holdings (Bermuda) Ltd.	67 Holding Co.	A. Jameel	26.0	ACQ (100%)	C
	Nasco Reinco Inc.	NY	63 Insurance Brokerage	Nasco Karoglan	63 Insurance Brokerage		NA	NB	P
	National Bank of Georgia	GA	60 Banking			G. Pharaon	7.0	EI (60% to 98.3%)	C

* (Later reduced to 16%)

4.

1980

SOURCE COUNTRY	US COMPANY	STATE	US INDUSTRY	FOREIGN OWNER	INDUSTRY OF FOREIGN OWNER	FOREIGN BENEFICIAL OWNER	COST OF TRANSACTION $ MILLIONS	TYPE OF TRANSACTION	STATUS OF TRANSACTION
Saudi Arabia	Nepple Farm (226.32 Acres)	IO	02 Farms			5 Unidentified Investors	0.4	ACQ (100%)	C
	Oasis Petroleum Corp.	CA	55 Gasoline Stations			E. Khashoggi	NA	ACQ (50%)	C
	Office Development (297,00 sq. ft.)	FL	65 Real Estate	Jameel Holdings (Bermuda) Ltd.	67 Holding Co.	A. Jameel	24.0	CON (100%)	C
	Salt Lake International Center	UT	65 Real Estate	Triad Holding Co. Ltd. (United Kingdom)	67 Holding Co.	Khashoggi Brothers	NA	CON	C
	Saudi Report International	TX	27 Periodicals Publishing	Saudi Research & Marketing Inc.		Hafiz Family	NA	NOF	C
	Sunshine Mining Co.	TX	10 Silver Mining	Arab Investors Group SA	67 Investment Holding Co.	F. Abu Khadra et al	10.6	EI (19% to 26.2%)	C
	Sunshine Mining Co.		10 Silver Mining	Arab Investors Group	67 Investment Holding Co.	F. Abu Khadra et al	1.3	PE	C

5.

1980 /

SOURCE COUNTRY	US COMPANY	STATE	US INDUSTRY	FOREIGN OWNER	INDUSTRY OF FOREIGN OWNER	FOREIGN BENEFICIAL OWNER	COST OF TRANSACTION $ MILLIONS	TYPE OF TRANSACTION	STATUS OF TRANSACTION
Saudi Arabia	Wineglass Ranch	CO	02 Ranch			B. Al-Faisal	1.0	ACQ (100%)	C
United Arab Emirates	National Bank of Abu Dhabi	DC	60 Banking	National Bank of Abu Dhabi	60 Banking	Government of Abu Dhabi	NA	NS	P
	Oceaneering International Inc.	TX	73 Underwater Contractor	Somico Navigation Co. Inc.	73 Marine Services		7.5	ACQ (20%)	C
Venezuela	Bariven Corp.	TX	13 Oil/Gas Exploration & Development	Petroleos de Venezuela SA	13 Oil/Gas Exploration & Development	Government of Venezuela	NA	NOF	C

1981 (JANUARY - JUNE) OPEC DIRECT INVESTMENT IN THE UNITED STATES

SOURCE COUNTRY	US COMPANY	STATE	US INDUSTRY	FOREIGN OWNER	INDUSTRY OF FOREIGN OWNER	FOREIGN BENEFICIAL OWNER	COST OF TRANSACTION $ MILLIONS	TYPE OF TRANSACTION	STATUS OF TRANSACTION
Kuwait	AZL Resources Inc.-Kuwait Petroleum Corp. Oil Drilling Venture	AZ	13 Oil/Gas Exploration & Development	Kuwait Petroleum Corp.	13 Oil/Gas Exploration & Development	Government of Kuwait	50.0	JV (50%)	P
	Hawaiian Independent Refinery Inc. (Pacific Resources Inc.)	HI	29 Oil Refining	Kuwait Petroleum Corp.	13 Oil/Gas Exploration & Development	Government of Kuwait	185.0	JV (50%)	P
	Hotel Statler	NY	70 Hotels			H. Antiqui	10.0	ACQ (100%)	C
	Independent Refinery Corp.	TX	29 Oil Refining			Unidentified Investor Group	NA	ACQ	C
	Uni International Corp.	TX	29 Oil Refining			Unidentified Investor Group	NA	ACQ	C
Saudi Arabia	Fashion Two Twenty Inc.	OH	28 Cosmetics			H.M. Alamoudi	NA	EI (36.7% to 62%)	C
	Donaldson, Lufkin & Jenrette, Inc.	NY	62 Brokerage	Competrol Establishment (Liechenstein)	67 Holding Co.	K. Al-Saud & S. Olayan	3.8	EI (11.5% to 14.4%)	C

2.

1981 /

SOURCE COUNTRY	US COMPANY	STATE	US INDUSTRY	FOREIGN OWNER	INDUSTRY OF FOREIGN OWNER	FOREIGN BENEFICIAL OWNER	COST OF TRANSACTION $ MILLIONS	TYPE OF TRANSACTION	STATUS OF TRANSACTION
Saudi Arabia	Hyatt International Corp.	IL	70 Hotels	GRP Investments NV		G. Pharaon	56.6	EI (16% to 100%)	P
	New Gibsons Inc.	TX	53 Retail Stores			G. Pharaon	1.5	ACQ (37%)	C
	Silver Dollar Mining Co. et al	ID	10 Silver Mining	Mediter-ranee Investors Group SA* (Luxembourg)	67 Holding Co.	F. Abu-Khadra et al	11.4	ACQ (22.1%)	P
United Arab Emirates	Middle East Bank Ltd. Federal Branch	NY	60 Banking	Middle East Bank Ltd.	60 Banking		NA	NFB	P
Venezuela	American Petrofina Inc.'s Refinery	TX	29 Oil Refining	Sociedad Financiera Credival CA et al	61 Finance	V. Perez Sandoval	NA	TOA	P

* Formerly Arab Investors Group SA.

KEY - Transaction Type/Status

Source: Michael A. Goodwin
Office of International Investment
U.S. Department of Commerce

Date: July 1981

- ACQ - Acquisition
- CON - Construction
- EI - Equity Increase
- JV - Joint Venture
- NAG - New Agency
- NB - New Branch
- NFB - New Federal Branch
- NOF - New Office
- NOT - New Outlet
- NP - New Plant
- NS - New Subsidiary
- TOA - Transfer of Assets
- C - Complete
- P - Pending

Industries listed by Standard Industrial Classification numbers.

ITA

OPEC Direct Investments

1974-1979

U.S. Department of Commerce
International Trade Administration
Office of Foreign Investment in the United States

December 1980

U.S. DEPARTMENT OF COMMERCE
International Trade Administration

OPEC Direct Investment in the United States, 1979

The Office of Foreign Investment in the United States (OFIUS) annually issues tabular and descriptive text on OPEC direct investment in the United States pursuant to its ongoing monitoring and public information program. The following presentation discusses 1979 investment transactions activity based on public source information and includes listings of OPEC countries.*

Transaction Figures

OPEC direct investment transactions recorded by the Office of Foreign Investment in the United States rose 18 percent over the 1978 total. In 1979, OFIUS identified 36 cases of OPEC direct investment in the United States with values available for 20 transactions totalling $350.6 million. Thirty-three transactions were completed, with values identified for 17 totalling $158.5 million. The 4 pending transactions at yearend 1979 had a reported total value of $192.1 million, mostly accounted for by the tender offer for Financial General Bankshares Inc. (FGB). At yearend, the tender offer was worth $134.5 million and was the largest single OPEC transaction value identified for the year.

These 36 OPEC transactions represent 2.7 percent of the 1,312 foreign direct investments identified by OFIUS in 1979. The $350.6 million total value of OPEC transactions is 1.9 percent of the $18.2 billion total value of all recorded direct investments for last year. OPEC transactions accounted for 3 percent of the 1979 total of 1,035 completed transactions recorded by OFIUS. The 17 OPEC completed transactions values added up to $188.1 million, 1 percent of the total value of $14.7 billion for the 541 completed transactions recorded by OFIUS last year.

Source Country, Industrial and Geographic Distribution

Saudi Arabia led in the number of transactions with 17, followed by Iran with 6 and Venezuela with 4 transactions. By value, Saudi Arabian, Venezuelan and Libyan investments totalled $333.6 million, 95 percent of the year's OPEC total. Saudi Arabia accounted for the largest amount - $264.7 million. Venezuela was next with $43.9 million for 4 transactions, all

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* The OPEC countries are Algeria, Ecuador, Gabon, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates, and Venezuela.

located in Florida. Libya followed with 2 transactions valued at $25 million.

The largest completed transaction recorded by OFIUS was a $49.1 million real estate acquisition. In February 1979, Abdul Latif Jameel, a Saudi Arabian businessman, purchased a Miami, Florida office building, One Biscayne Tower. The acquisition was made through his Netherlands Antilles holding company One Biscayne Tower N.V.

The most frequent type of OPEC direct investment was by acquisition, which accounted for about two-thirds (25 cases) of the OPEC transactions. The next most frequently identified investment mode was construction (4 cases) followed by equity increases (3 cases).

OPEC investors were most active in the real estate and hotel industries in 1979. They indicated values in 10 of 14 recorded real estate transactions totalling $119.0 million, either real property acquisitions or construction. The hotels sector had 7 transactions with 3 recorded values totalling $18.1 million. There were 6 total or partial acquisitions and 1 hotel construction in this sector. OPEC investors were also active in the wholesale trade and manufacturing sectors, and two pending transactions in the banking sector had a total value of $152.5 million.

Seventy percent of the OPEC investments were located in 5 states. Florida had 7 transactions and Texas 6 transactions. California accounted for 5 transactions, while New York and North Carolina each listed 3 transactions.

Major Developments

There were a number of major developments during the year. In July 1979, Joseph C. Canizaro, a Louisiana developer, who in 1976 went into partnership with the Government of Iran, through the state-owned Bank Omran, to build Canal Place, a commercial and residential complex in New Orleans, purchased the Iranian interest in the half-billion-dollar project for $50 million. Since the new Iranian government reportedly retains an interest in the project through a $1.5 million loan, the government's status is no longer that of direct investor.

In the course of the year, a group of Saudi, Kuwaiti, and Abu Dhabi investors renewed their efforts to acquire control of Financial General Bankshares (FGB), the Washington-based $2.2 billion bank holding company. The group raised their original offer of $15 per share for all stock, and at yearend '79 had notified the Securities and Exchange Commission that they wanted to put the acquisition issue to a vote at FGB's next shareholders' meeting. The group was prepared to offer $25 per share for all FGB stock if shareholders approved a resolution recommending that the company's directors and officers remove all barriers to a takeover offer. The Middle East investors contended they had been unable to make a formal offer of $25 because of actions by FGB's management.

The first major investment by investors from the OPEC countries in the United States precious metals industry took place in December 1979 when Arab Investors Group SA, a Luxembourg corporation, bought more than one million shares, 19 percent, of Sunshine Mining Co. for $21.9 million. In addition, the Dallas-based mining firm, which operates and holds the majority share of the nation's biggest silver mine, granted the Arab Investors Group an option, which had to be exercised by January 31, 1980, to buy 500,000 additional shares for $10.6 million. Arab Investors Group is owned by some two dozen individual investors, mostly from Saudi Arabia and Kuwait, and most of the company's holdings are in European and African banks.

Inquiries and/or comments on this data should be addressed to:

The Office of Foreign Investment in the United States
U.S. Department of Commerce
Room 6093
Washington, DC 20230
(202) 377-2568

OPEC DIRECT INVESTMENT IN THE UNITED STATES
1974-79 TRANSACTIONS

--1974 OPEC DIRECT INVESTMENT IN THE UNITED STATES--

SOURCE COUNTRY	US COMPANY	STATE	US INDUSTRY	FOREIGN OWNER	INDUSTRY OF FOREIGN OWNER	FOREIGN BENEFICIAL OWNER	COST OF TRANSACTION $ MILLIONS	TYPE OF TRANSACTION	STATUS OF TRANSACTION
Iran	DePinna Building	NY	650 Real Estate	Pahlevi Foundation	673 Foundation	Gov't of Iran	8.6	ACQ	C
Kuwait	Atlanta Hilton	GA	701 Hotels	Kuwait Investment Co.	671 Holding Co.	Gov't of Kuwait	10.0	ACQ (50%)	C
	Kiawah Island	SC	650 Real Estate	Kuwait Investment Co.	671 Holding Co.	Gov't of Kuwait	17.4	ACQ/JV	C
	Land	NJ	650 Real Estate			Unidentified Investor	25.0	ACQ (100%)	C
	Office Building	NJ	650 Real Estate			Unidentified Investor	5.0	ACQ (100%)	C
	Property	NJ	650 Real Estate			Unidentified Investor	10.0	ACQ (100%)	C
Saudi Arabia	Arizona-Colorado Land & Cattle Co.	AZ	021 Beef Cattle	Triad Holding Co. (Lebanon)	671 Holding Co.	A. M. Khashoggi	9.4	ACQ (15.3%)	C

--1975 OPEC DIRECT INVESTMENT IN THE UNITED STATES--

SOURCE COUNTRY	US COMPANY	STATE	US INDUSTRY	FOREIGN OWNER	INDUSTRY OF FOREIGN OWNER	FOREIGN BENEFICIAL OWNER	COST OF TRANSACTION $ MILLIONS	TYPE OF TRANSACTION	STATUS OF TRANSACTION
Kuwait	Kirby Building Systems Inc.	TX	344 Prefab. Metal Bldgs	Yusuf A. Alghanim & Sons	509 Trading Co.	Alghanim Family	5.5	ACQ (95%)	C
	Kirby Real Estate Investment Corp.	TX	671 Holding Co. Real Estate	Yusuf A. Alghanim & Sons	509 Trading Co.	Alghanim Family	5.5	ACQ (95%)	C
Saudi Arabia	Bank of the Commonwealth	MI	602 Banking	Saudi Research & Dev. Corp.	671 Holding Co.	G. Pharaon	10.0	ACQ (32%)	C
Venezuela	Int'l Basic Economy Corp.	NY	671 Holding Co.	Organisa-tion ADAC, C.A.	671 Holding Co.		20.0	ACQ (22%)	C

-- 1976 OPEC FOREIGN DIRECT INVESTMENT IN THE UNITED STATES --

SOURCE COUNTRY	US COMPANY	STATE	US INDUSTRY	FOREIGN OWNER	INDUSTRY OF FOREIGN OWNER	FOREIGN BENEFICIAL OWNER	COST OF TRANSACTION $ MILLIONS	TYPE OF TRANSACTION	STATUS OF TRANSACTION
Iran	Canal Place (w/J. Canizaro)	LA	650 Real Estate	Bank Omran	600 Banking	Gov't of Iran	250.0	JV	C
	Rancho Matilija (Cattle Ranch)	CA	650 Real Estate			Mohseni Family	2.5	ACQ (100%)	C
Kuwait	Atlanta Center Ltd.	GA	701 Hotels	Kuwait Investment Co.	671 Holding Co.	Gov't of Kuwait	10.0	EI (From 50% to 100%)	C
	Vallco Park Ltd.	CA	650 Realty Hdg.	Kuwait Investment Co.	671 Holding Co.	Gov't of Kuwait	NA	ACQ (33 1/3%)	C
	Columbia Plaza Office Building	DC	650 Real Estate	Kuwait Investment Co.	671 Holding Co.	Govt't of Kuwait	22.0	ACQ (100%)	C
Saudi Arabia	Arabian Shield Development Co.	TX	138 Oil and Gas Field Development Services			A. Abdul Aziz et al	2.5	ACQ (36%)	C
	Bank of the Commonwealth	MI	602 Banking	Saudi Research & Dev. Corp.	671 Holding Co.	G. Pharaon	NA	EI (To 32+%)	C
	Industrial Park (750-Acres)	UT	650 Real Estate			A. M. Khashoggi	NA	CON	C
	Thermo Electron Corp.	MA	367 Elec. Comps.	Olayan Investments Co. NV	671 Holding Co.	S. Olayan	NA	ACQ (16.1%)	C
	Sam P. Wallace Co.	TX	154 Commercial Constr.	GRP Investments NV (Neth. Ant.)	671 Holding Co.	G. Pharaon	1.0	ACQ (38%)	C

-- 1977 OPEC DIRECT INVESTMENT IN THE UNITED STATES --

SOURCE COUNTRY	US COMPANY	STATE	US INDUSTRY	FOREIGN OWNER	INDUSTRY OF FOREIGN OWNER	FOREIGN BENEFICIAL OWNER	COST OF TRANSACTION $ MILLIONS	TYPE OF TRANSACTION	STATUS OF TRANSACTION
Iran	Bank Melli Iran Agency	CA	600 Banking	Bank Melli Iran	600 Banking		NA	NAG	C
	Bank Saderat Iran Agency	CA	600 Banking	Bank Saderat Iran	600 Banking		NA	NAG	C
	Bank Sanye Iran Agency	NY	600 Banking	Bank Sanye Iran	600 Banking		NA	NAG	C
	House of Iran Ltd.	CA	581 Restaurant			Gov't of Iran	NA	NP	C
Kuwait	Galleria	TX	650 Real Estate	Kuwait Investment Co.	671 Holding Co.	Gov't of Kuwait	15.0	ACQ	C
	Hotel	NV	701 Hotels	Eastern Star Corp.			80.0	CON	P
	Castle	AZ	650 Real Estate			N. Mabarak	0.3	ACQ (100%)	C
Nigeria	Embassy Building	NY	650 Real Estate			Gov't of Nigeria	0.8	ACQ (100%)	C
	International Systems Inc.	AL	327 Prefab. Housing			G. Pharaon	NA	NP	C
Saudi Arabia	Koniag Inc.	AK	131 Oil and Gas			Gov't of Saudi Arabia	NA	JV	P
	Land (32,000-Acre Tract) & Mineral Rights	LA	650 Real Estate	Inman Investments	671 Holding Co.	G. Pharaon	4.0	ACQ (50%)	C

-- 1977 OPEC DIRECT INVESTMENT IN THE UNITED STATES -- (Cont'd)

SOURCE COUNTRY	US COMPANY	STATE	US INDUSTRY	FOREIGN OWNER	INDUSTRY OF FOREIGN OWNER	FOREIGN BENEFICIAL OWNER	COST OF TRANSACTION $ MILLIONS	TYPE OF TRANSACTION	STATUS OF TRANSACTION
Saudi Arabia	Main Bank of Houston	TX	602 Banking			G. Pharaon & K. B. Mahfouz	NA	ACQ (90%)	C
	National Bank of Georgia	GA	602 Banking			G. Pharaon	14.4	ACQ (60%)	C
Venezuela	Beach Property	FL	650 Real Estate			Unidentified Venezuelan Investors	1.1	ACQ (100%)	C
	Chelsea National Bank	NY	602 Banking	Banco Union	600 Banking		0.4	ACQ (100%)	C
	First National Bank of Hialeah	FL	602 Banking			J. Stelling	12.0	ACQ (52%)	C
	Litco Corp.	NY	671 Holding Co.			M. Benacerras	NA	ACQ	P
	Petroleos De Venezuela	NY	131 Oil and Gas	Petroleos De Venezuela SA	131 Oil and Gas	Gov't of Venezuela	NA	NOF	C

-- 1978 OPEC DIRECT INVESTMENT IN THE UNITED STATES --

SOURCE COUNTRY	US COMPANY	STATE	US INDUSTRY	FOREIGN OWNER	INDUSTRY OF FOREIGN OWNER	FOREIGN BENEFICIAL OWNER	COST OF TRANSACTION $ MILLIONS	TYPE OF TRANSACTION	STATUS OF TRANSACTION
Algeria	Sonatrach	TX	286 Indus. Organic Chemicals	Societe Nationale Sonatrach	516 Wholesale Chemicals	Gov't of Algeria	NA	NOF	C
Iran	Bank Sepah Iran Agency	NY	600 Banking	Bank Sepah	600 Banking		NA	NAG	C
	D.S.&K. Development	CA	655 Real Estate Development			H. Ghomeshi et al	3.0	ACQ (50%)	C
	Holyoke Shopping Center	MA	650 Real Estate			Kashi Family	0.5	ACQ (100%)	C
	Mission Plaza Shopping Center	CA	650 Real Estate			H. Samimi	0.8	ACQ (100%)	C
	New Atlanta Hotel	VA	701 Hotels			B. Mahdi	0.1	ACQ	C
	Office Building	CA	650 Real Estate			H. Samimi	1.1	ACQ (100%)	C
	REI Inc.	TX	890 Misc. Services	Research Engineers Int'l			NA	NS	C

-- 1978 OPEC DIRECT INVESTMENT IN THE UNITED STATES -- (Cont'd)

SOURCE COUNTRY	US COMPANY	STATE	US INDUSTRY	FOREIGN OWNER	INDUSTRY OF FOREIGN OWNER	FOREIGN BENEFICIAL OWNER	COST OF TRANSACTION $ MILLIONS	TYPE OF TRANSACTION	STATUS OF TRANSACTION
Kuwait	Baltimore Hilton	MD	701 Hotels	United Int'l Hotels	701 Hotels		4.5	ACQ	P
	Burkyarns Inc.	NC	228 Yarn Spinning Mill	Naseus Inc.	671 Holding Co.	K. A. H. Al Sagar & H. Shaikh	1.0	ACQ (54.3%)	C
	Landmark Hotel	NV	701 Hotels			G. A. Aziz	13.5	ACQ (100%)	P
	Petra Capital Corp.	NY	621 Investment Banking	Kuwait Financial Center	671 Holding Co.	A. Al Sabah et al	2.5	NO (70%)	C
	Solid State Technology Inc.	MA	366 Fire Alarm Boxes	Arabian Construction Co.	171 Construction Co.		NA	ACQ	C
Saudi Arabia	Arab News	DC	271 Newspaper Publishing	Saudi Research & Marketing Co.	271 Newspaper Publishing	Hafiz Family	NA	NOF	C
	Babst Services Inc.	LA	171 Constr.	GRP Investments NV (Neth. Ant.)	671 Holding Co.	G. Pharaon	6.7+	ACQ (38%)	C
	CRS Design Associates Inc.	TX	891 Constr. Mgmt.	GRP Investments NV (Neth. Ant.)	671 Holding Co.	G. Pharaon	5.6	ACQ (20%)	C
	Donaldson, Lufkin and Jenrette Inc.	NY	621 Security Brokers	Competrol Establishment (Liechtenstein)	671 Holding Co.	K. Al Saud & S. Olayan	5.0	EI (5.7% to 11.4%)	C
	Financial General Bankshares Inc.	DC	671 Holding Co. Banking	Bank of Credit & Commerce Int'l (U.K.)	600 Banking	K. Adham, F. S. Al Fulaij et al	18.0	ACQ (18.5%)	C

1978 OPEC FOREIGN DIRECT INVESTMENT IN THE UNITED STATES (Cont'd)

SOURCE COUNTRY	US COMPANY	STATE	US INDUSTRY	FOREIGN OWNER	INDUSTRY OF FOREIGN OWNER	FOREIGN BENEFICIAL OWNER	COST OF TRANSACTION $ MILLIONS	TYPE OF TRANSACTION	STATUS OF TRANSACTION
Saudi Arabia	Land-Galleria (22-Acre Tract)	TX	650 Real Estate			A. M. Khashoggi	NA	ACQ (100%)	C
	Plaza of the Americas Inc.	TX	650 Real Estate			G. Pharaon	7.0	CON (45%)	C
	RLC Corp.	DE	421 Trucking	GRP Investments NV (Neth. Ant.)	671 Holding Co.	G. Pharaon	NA	ACQ (20%)	C
	Shakerag Farms	GA	650 Real Estate	Hanoon Investment Co. (Neth.)		Unidentified Investors	3.0	ACQ (100%)	C
	Switzer Mesa	AZ	650 Real Estate	Fairburn Associates Inc.			NA	CON	P
	Transmarket Services	DC	739 Translation Services	Arab World Public Relations	671 Holding Co.	N. Ghadry	NA	NS	C
	Union Bank Building	CA	650 Real Estate			Unidentified Investors	60.0	ACQ	C
	Warner Plaza	CA	650 Real Estate			H. F. Aswad	NA	CON	C
Venezuela	Apartment House	NY	650 Real Estate			Unidentified Investors	NA	ACQ (100%)	C
	Banco De Venezuela	NY	602 Banking	Banco De Venezuela, SA	600 Banking		NA	NAG	C
	Beachfront Property	FL	650 Real Estate			Unidentified Investors	17.0	ACQ (100%)	P

-- 1979 OPEC DIRECT INVESTMENT IN THE UNITED STATES --

SOURCE COUNTRY	US COMPANY	STATE	US INDUSTRY	FOREIGN OWNER	INDUSTRY OF FOREIGN OWNER	FOREIGN BENEFICIAL OWNER	COST OF TRANSACTION $ MILLIONS	TYPE OF TRANSACTION	STATUS OF TRANSACTION
Iran	Baldwin Steel Co.	NJ	505 Metals Service Center	Deutsche Babcock & Wilcox AG (W. Germ.)	154 General Contractor	Gov't of Iran	NA	ACQ (100%)	C
	Bonanza Restaurant	TX	581 Restaurant			Unidentified Investor	NA	NOT	C
	Century Bank Plaza Office Building	CA	650 Real Estate			J. Daneshgar et al	NA	ACQ (100%)	C
	Coachman Industries of California Inc.'s Plant	CA	379 Trailers			Unidentified Investors	1.0	ACQ/JV	C
	Office/Retail	CA	650 Real Estate			Unidentified Investors	NA	CON	C
	Whiting Ranch (2,769 Acres)	CA	650 Real Estate			J. Daneshgar et al	12.0	ACQ (100%)	C
Iraq	Hilton Hotel (Greensboro)	NC	701 Hotels	Hotel Caroline Inc. NV (Neth. Antilles)	NA	J. Al Baker	NA	ACQ (100%)	C
	Hilton Hotel (Raleigh)	NC	701 Hotels	Hotel Caroline Inc. NV (Neth. Antilles)	NA	J. Al Baker	NA	ACQ (100%)	C

-- 1979 OPEC DIRECT INVESTMENT IN THE UNITED STATES -- (Cont'd)

SOURCE COUNTRY	US COMPANY	STATE	US INDUSTRY	FOREIGN OWNER	INDUSTRY OF FOREIGN OWNER	FOREIGN BENEFICIAL OWNER	COST OF TRANSACTION $ MILLIONS	TYPE OF TRANSACTION	STATUS OF TRANSACTION
Iraq	Hilton Hotel (Winston-Salem)	NC	701 Hotels	Hotel Caroline Inc. NV (Neth. Antilles)	NA	J. Al Baker	NA	ACQ (100%)	C
Kuwait	Baltimore Hilton	MD	701 Hotels			Unidentified Investors	NA	ACQ (100%)	C
	Executive Square Office Building	MD	650 Real Estate			Unidentified Investor	4.0	ACQ (100%)	C
Libya	Libyan Diplomatic Mission Building	NY	650 Real Estate			Gov't of Libya	13.0	CON	C
	One Broadway Office Building	NY	650 Real Estate			Unidentified Investor	12.0	ACQ (100%)	C
Saudi Arabia	Beacon Hill (A. Godfrey Estate)	VA	021 Cattle Farm	The Vanguard Co. (Neth. Antilles)		T. Al Saud	5.2	ACQ (100%)	C
	Land-Commercial Property Dev. (376 Acres)	VA	650 Real Estate			Unidentified Investors	NA	ACQ (100%)	C

-- 1979 OPEC DIRECT INVESTMENT IN THE UNITED STATES -- (Cont'd)

SOURCE COUNTRY	US COMPANY	STATE	US INDUSTRY	FOREIGN OWNER	INDUSTRY OF FOREIGN OWNER	FOREIGN BENEFICIAL OWNER	COST OF TRANSACTION $ MILLIONS	TYPE OF TRANSACTION	STATUS OF TRANSACTION
Saudi Arabia	Eberline Instrument Corp.	NM	382 Measuring Instruments			S. Olayan et al	NA	ACQ (22.1%)	C
	Financial General Bankshares Inc.	DC	671 Holding Co. Banking	Int'l Credit & Commerce Overseas (Grand Cayman Island)	671 Holding Co.	K. Adham, F. S. Al Fulaij et al	134.5	EI (From (18.5%) to 100%)	P
	Hotel	AL	701 Hotels	Saudi Research & Development Corp.	671 Holding Co.	G. Pharaon	10.0	CON	P
	Hyatt International Corp.	IL	701 Hotels			G. Pharaon	3.6	ACQ (21.4%)	C
	Ivanhoe Hotel	FL	701 Hotels	Tahlawi Holding Co. Ltd.	671 Holding Co.	W. Tahlawi	4.5	ACQ (100%)	C
	Land (75,000 Square Feet)	CO	650 Real Estate			M. Kayal	0.7	ACQ (100%)	C
	Land (138-Acre Tract)	FL	650 Real Estate			A. M. Baroom	3.1	ACQ (100%)	C
	Land (376 Acres)	VA	650 Real Estate			Unidentified Investor	2.6	ACQ (100%)	C

-- 1979 OPEC DIRECT INVESTMENT IN THE UNITED STATES -- (Cont'd)

SOURCE COUNTRY	US COMPANY	STATE	US INDUSTRY	FOREIGN OWNER	INDUSTRY OF FOREIGN OWNER	FOREIGN BENEFICIAL OWNER	COST OF TRANSACTION $ MILLIONS	TYPE OF TRANSACTION	STATUS OF TRANSACTION
Saudi Arabia	Metallurgical Inc.	MN	339 Metal Heat Treating	Olayan Investments Co. NV (Neth. Ant.)	671 Holding Co.	S. Olayan	NA	ACQ (16.1%)	C
	One Biscayne Tower Office Building	FL	650 Real Estate	One Biscayne Tower NV (Neth. Ant.)		A. Jameel	40.1	ACQ (100%)	C
	Petronal	TX	517 Wholesale Petroleum	Petromin	131 Crude Pet. & Nat. Gas	Gov't of Saudi Arabia	NA	NO	C
	Saudi Report	TX	272 Period Pub.	Saudi Research & Marketing Inc.	272 Period Pub.	Hafiz Family	NA	NS	C
	Sunshine Mining Co.	TX	104 Silver Mining	Arab Investors Group (Luxembourg)	671 Holding Co.	F. Abu Khadra et al	21.8	ACQ (19%)	C
	Tia Shan Restaurant	TX	581 Restaurant	USA Shangri La Inc.	509 Misc. Durable Goods	R. L. Tan	NA	ACQ (100%)	C
	Sam P. Wallace Inc.	TX	171 Constr.	GRP Investments NV (Neth. Ant.)	671 Holding Co.	G. Pharaon	NA	EI (From 36% to 65%)	C
	Whittaker Corp.	CA	505 Metals Service	Olayan Investments Co. Establishment (Liechtenstein)	671 Holding Co.	S. Olayan	29.6	EI (From .003% to 13.6%)	P

-- 1979 OPEC DIRECT INVESTMENT IN THE UNITED STATES -- (Cont'd)

SOURCE COUNTRY	US COMPANY	STATE	US INDUSTRY	FOREIGN OWNER	INDUSTRY OF FOREIGN OWNER	FOREIGN BENEFICIAL OWNER	COST OF TRANSACTION $ MILLIONS	TYPE OF TRANSACTION	STATUS OF TRANSACTION
United Arab Emirates	Warner Communications Building	NY	650 Real Estate			A. Fayed & M. Fayed	NA	ACQ (100%)	C
Venezuela	Berlioz Dairon	FL	512 Wholesale Cosmetics	Berlioz Dairon SA	284 Cosmetics		3.4	NOT	C
	Coral Springs Mall	FL	650 Real Estate	Cartagena Holding Co. NV	671 Holding Co.	L. Nunez	12.5	ACQ (100%)	C
	Florida National Banks of Florida Inc.	FL	671 Holding Co. Banking	Tenedora de Valores Financieros CA & 9 other companies	671 Holding Co.	E. Delfino et al	18.0	ACQ (17.5%)	P
	Smokehouse Bay Club Condominium	FL	650 Real Estate			R. Clocca K. Bauer R. Dellsburger	10.0	CON	C

Union Calendar No. 757

96th Congress, 2d Session - - - - - - - House Report No. 96-1216

(EXCERPTS FROM:)

THE ADEQUACY OF THE FEDERAL RESPONSE TO FOREIGN INVESTMENT IN THE UNITED STATES

TWENTIETH REPORT

BY THE

COMMITTEE ON GOVERNMENT OPERATIONS

together with

ADDITIONAL VIEWS

AUGUST 1, 1980.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1980

I think that in the European economic community the information-gathering system has improved considerably over the last 10 years, compared to ours. . . . I would say that of the major host countries of the world, *we would be at the bottom*, even among the industrialized countries. . . . Countries like France and Great Britain have better systems of monitoring their foreign investment than the United States does. *There are very few major countries in the world today that are as naive and ignorant concerning the size and nature of foreign investment in their countries as the United States is.*[1] (Emphasis added.)

1. Commerce Department (BEA and OFIUS)

a. OPEC Investment Data Gaps (Case Studies)

I

BEA and OFIUS are the two Federal entities primarily responsible for monitoring direct investment. A comparison of their lists of OPEC country direct investments in the United States, furnished to the subcommittee in July 1979, casts serious doubts on the accuracy and completeness of the data.

OFIUS' list of publicly reported transactions reveals 68 OPEC country direct investments (71 were listed, but 3 were duplicates).[2] While not disclosing the name or details of OPEC investments, BEA did furnish a table of OPEC country investments, broken down by both country and by industry sector.[3] (The BEA data is based on BEA's statistical surveys.)

The BEA list does not include 23 of the 68 OPEC investments listed by OFIUS. While it is difficult to determine whether many of the remaining investments on the OFIUS list are on the BEA list,[4] these 23 non-matches are definitely demonstrated, because the BEA list shows no investment for the OPEC country in question with an industry code description even close to that in the OFIUS entry.

Mr. Manawar Hidayatallah testified before the subcommittee, describing but not naming, five U.S. firms owned by Development Industrial Corporation, which he heads, a holding company owned by nine investors of Saudi, Syrian, and British nationality.[5] Normally, these five firms would appear in the BEA list of OPEC investments under the Saudi Arabia heading, yet it appears that only one of the five appears there. BEA's system therefore missed four investments in addition to the 23 previously noted. In addition, none of these five firms is on the OFIUS list.

A 1979 State Department airgram describes seven U.S. companies owned by Saudi interests and an eighth which is affiliated with a Saudi

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[1] Ibid., p. 9.
[2] Hearings (Part 2), pp. 169–197.
[3] Ibid., p. 180.
[4] The remaining 43 OFIUS listings are probably picked up in the BEA list, although there are considerable uncertainties in this category. However, the doubts—which were numerous—were resolved in favor of agreement between the two. Thus, for example, OFIUS entries describing investments as "Banking" and "602" were considered equivalent to BEA entries with the code "600." BEA's refusal to share identifying data with the subcommittee is illegal and will be discussed further in Section VIII, "Reporting."
[5] Hearings (Part 2), pp. 133–146.

parent company.[6] Only two of these eight firms could possibly fit the descriptions of companies on the BEA list, and, therefore, six are definitely not included by BEA. Further, only one of these eight companies is on the OFIUS' list.

Finally, the Federal Reserve Board furnished a list to the subcommittee showing a 1979 acquisition of the Pan American National Bank of Los Angeles by Indonesian interests.[7] This acquisition is not on the BEA list nor the OFIUS list of OPEC investments.

In sum, there are at least 34 OPEC country investments which were missed in some way by BEA's data collection system, and at least 13 missed by OFIUS. (It should be noted that BEA was aware of these omissions.)

II

Examining Iranian direct investment in the United States is equally instructive. On March 20, 1980, the Secretary of Commerce advised the subcommittee that BEA's figures showed $5 million of Iranian FDI in the United States, $1 million of which is real estate, at the time of the American freeze of Iranian assets in the United States.[8]

This figure greatly understates the real amount of Iranian FDI in the United States. Both OFIUS and newspaper accounts reveal two major Iranian investments. The first is a shopping [office] residential complex in New Orleans, called Canal Place. The completed development is projected at a cost of $500 million; and the first phase, well underway, will cost $250 million.[9] The second is an office building, built and formerly owned by the Pahlavi Foundation, located on Fifth Avenue in New York City, which cost around $50 million.[10] Further, Iranians invested approximately $15 million in First Wisconsin Corporation, a banking company.[11] OFIUS' July 1979 list of OPEC investments reveals 15 additional Iranian investments, (beside Canal Place), seven of which total at least $16 million; (OFIUS did not have figures for the remaining eight).

BEA measures inflows of capital from abroad and not total investment amounts (which would include funds borrowed here), while OFIUS and newspaper accounts reveal total investment figures over the life of the investment. Normally, this limited BEA measure would account for some discrepancy. However, given the magnitude of the $81 million in known Iranian direct investments, (an addition of the amounts noted in the preceding paragraph), which excludes (1) the massive investment in Canal Place and (2) the eight remaining OFIUS investments of unknown value, it is inconceivable that Iranian inflows totaled only $5 million, all prior to the freeze. Even if BEA's figure on inflows were accurate, this $5 million figure would dramatically misrepresent the true dollar value and impact of Iranian direct investments in the United States.

The apparent unreliability of BEA's figures is confirmed by a February 2, 1979, confidential government memo, dealing with Iranian assets in the United States. The memo states in part:

[6] Ibid., pp. 181–194.
[7] Hearings (Part 4), p. 78.
[8] Hearings (Part 5), Appendix 6.
[9] Forbes, Dec. 15, 1977, p. 78; Hearings (Part 2), p. 170.
[10] New York Times, Dec. 15, 1979 (two articles).
[11] New York Times, Dec. 5, 1979, pp. A1 and A22, and New York Times, Dec. 9, 1977, p. D10.

There is very little information available about Iranian-owned assets in the United States, since most transactions may be made *without encountering any reporting requirement* ... No one has any firm estimate of the size, distribution, or composition of Iranian private real assets in the United States ... [Further], real estate provides the Iranians with maximum anonymity ... All this suggests that Iranians have been moving some of their wealth in U.S. real estate, but there is no good estimate of the amount of dollars involved.[13] (Emphasis added.)

BUSINESS INTERNATIONAL MONEY REPORT, March 6, 1981

Arab Boycott Means No More SAMA Funds For World's Biggest Firm

Occasionally, arcane political actions have real financial consequences, as the recent consideration of the Euromarkets by American Telephone & Telegraph (AT&T) bears out. Several weeks ago, a senior financial executive of AT&T—whose $52 billion in 1980 revenues make it the world's biggest corporation—said that the US communications giant is for the first time considering issuing long-term Eurobonds.

Press reports at that time did not discuss the company's reasons for eyeing the Euromarkets. But *BIMR* has determined that a major reason behind the move is the fact that the firm will almost certainly be barred from its one source of international finance in recent years—the Saudi Arabian Monetary Agency (SAMA), which took AT&T private placements worth more than $600 million in 1977-78.

In addition to its requirement for solid financial security in its debtors and its adherence to certain nonbusiness criteria (such as not lending to any cigarette manufacturers, brewers or distillers), SAMA has repeatedly stressed that it will not lend to companies that are on the official Arab boycott list issued in Damascus. Companies find themselves on the list if they are considered to have done business with Israel or to have "aided Zionism."

BIMR has learned that for over a year now, AT&T has been on the boycott list, though the Arab move against the company has not been reported in the press. In fact, the US-Arab Chamber of Commerce was unaware of this listing. Nevertheless, *BIMR*'s correspondent in Jordan has unearthed the company's name from the official central list, which each Arab country follows as it sees fit. AT&T subsidiaries, such as Bell Laboratories and Teletype Co, are also listed.

A spokesman for AT&T International, Burt Wolder, confirms that his company is on the boycott list. He added, however, that AT&T has never sold any communications equipment or done any consulting work in Israel; as far as he knows, the firm's only business with that country is the connection of long-distance telephone calls.

But SAMA has always stated that it takes the boycott list literally. AT&T and its subsidiaries have received no SAMA funds since 1979, *BIMR* learned, and investment bankers who are close to SAMA doubt that the company will receive any more. There is no reason to believe, however, that the company's presence on the boycott list means a loss of potential sales to Saudi Arabia. Wolder says that the company has installed a major switching facility and communications network in Saudi Arabia, "and we expect that contact to continue."

WALL STREET JOURNAL, Sept. 14, 1981

World Briefs

Iraqi Oil Minister Reportedly Urges Arabs To Consider Pulling Oil Dollars From U.S.

KUWAIT—Iraqi Oil Minister Tayeh Abdul Karim urged Arabs to consider withdrawing surplus petrodollars from U.S. banks.

Mr. Abdul Karim also asserted that Arabs should "reconsider" keeping funds generated from oil sales in U.S. banks. "The question of Arab funds deposited in Western countries should be reconsidered because such balances do serve the interests of these countries, mainly the U.S., which openly antagonizes the Arabs and supplies Israel with tools of destruction," he said.

In an interview with the newspaper al-Rai al-Am he also said that the current glut on oil markets poses a threat to the unity of the Organization of Petroleum Exporting Countries. He discounted "any notion" of reducing oil prices as a way to combat the glut.

WASHINGTON POST, Sept. 20, 1981

Arab Hard-Liners Urge Closer Moscow Ties

BEIRUT, Sept. 19 (UPI) — Hard-line Arabs have ended summit talks in Libya with a call for closer ties with Moscow, a joint communique said today.

The conferees also urged the use of oil as a political weapon to counter the U.S.-Israeli strategic cooperation agreement, the communique said.

The high-level talks, which ended late yesterday, included the leaders of Algeria, Libya, South Yemen, Syria and the Palestine Liberation Organization, grouped in the so-called Arab Steadfastness and Confrontation Front.

The communique was released simultaneously by the official state radio services in Tripoli and Damascus.

The communique said the conferees decided to:

- Call on the forthcoming Arab summit, scheduled for November in Rabat, Morocco, to take deterrent measures against all Arab states that continue to cooperate with Egypt.
- Declare the United States in a state of direct confrontation with the Arabs.
- Include the issue of U.S.-Arab relations on the agenda of the Arab summit to take a unified position on these relations.
- Regard the new U.S.-Israeli strategic "alliance" as direct U.S. participation in the occupation of Palestine (Israel) and other Arab territories and any form of U.S. military presence in the "Arab homeland" as "hostile to our nation that should be fought and removed."
- Call on the Arabs to use all their economic resources, including oil and dollar deposits in American banks to confront the new strategic alliance between Israel and the United States.
- Call on the Arabs to enter negotiations with the Soviet Union and achieve a qualitative upgrading in relations to restore the balance of power in the region.

The conferees, according to the statement, also welcomed the strategic alliance reached last month between the three Soviet-backed states of South Yemen, Libya and Ethiopia and said it has contributed much to the struggle against the U.S.-sponsored Camp David accords between Israel and Egypt.

[Whereupon, the subcommittee adjourned, to reconvene subject to the call of the Chair.]

APPENDIXES

APPENDIX 1.—ADDITIONAL INFORMATION FROM THE TREASURY DEPARTMENT AND THIRD PARTY STATEMENTS

MAJORITY—(202) 225-4407

NINETY-SEVENTH CONGRESS
Congress of the United States
House of Representatives
COMMERCE, CONSUMER, AND MONETARY AFFAIRS
SUBCOMMITTEE
OF THE
COMMITTEE ON GOVERNMENT OPERATIONS
RAYBURN HOUSE OFFICE BUILDING, ROOM B-377
WASHINGTON, D.C. 20515

November 2, 1981

Hon. Marc E. Leland
Assistant Secretary of
Treasury for International Affairs
U.S. Department of the Treasury
Washington, D.C. 20220

Dear Mr. Leland:

As a follow-up to your September 23, 1981, appearance and testimony during the subcommittee's hearing on OPEC investments in the United States, we require additional information. Also, this letter will confirm my specific requests for certain other information, which I made during your appearance.

I

Please respond in detail to the following questions:

1. In a statement submitted to the subcommittee the Securities Industry Association recommended that the Treasury take corrective action to improve the U.S. Government's portfolio data collection efforts. How does Treasury intend to implement each of the SIA recommendations? What steps have already been taken? What other steps are under active consideration? Which recommendations have been rejected?

2. In a January 10, 1980, memorandum to Deputy Assistant Secretary Karlik from Dirck Keyser, (copy attached), there was some question on how Treasury

   "could get early warning of sudden politically-motivated withdrawals of funds from U.S. banks such as was threatened by the Iranians on November 13."

   The memo suggests the appointment of a "watch officer" who would closely monitor press, ticker, and classified intelligence reports and make market contacts. Has Treasury created such a post? If so, please furnish details, including (a) the name of the person and the office involved, (b) how this person functions, and (c) the degree of cooperation obtained from government and private sources. If Treasury did not create such a post, why not, and what steps has it taken to fulfill the need for an early-warning system?

3. In Governor Wallich's prepared statement of September 23, 1981, the Federal Reserve estimates the cumulative unidentified amount of the OPEC investible surpluses worldwide to be $8 billion. On page 7 of the annex to your statement, Treasury estimates this to be $57 billion. What accounts for this large discrepancy?

4. During your appearance, you responded that it is important to have direct investment data broken down country by country. The Commerce Department's Bureau of Economic Analysis (BEA) heretofore has refused to do that on an annual basis, for all OPEC and most non-OPEC countries. As chairman of CFIUS and chairman of the CCEA Working Group on International Investment, what action have you taken or will you take to secure country-by-country direct investment data? What has been BEA's response?

5. During the period between the subcommittee's 1979 hearing on foreign investment and the September hearing, Treasury did not publish any aggregate figures for OPEC investments in the U.S. Only certain flow figures for various categories and for different groups of OPEC nations were published in the Treasury Bulletin. Public and congressional interest in these figures is substantial. Please advise us whether Treasury intends to publish aggregate OPEC investment data (in a similar format as that furnished to the subcommittee) on an ongoing basis? If not, why not?

II

During your appearance, I requested that Treasury furnish to the subcommittee projections on OPEC country surpluses for the next five years. Please furnish those projections in the same format as followed on pages 15 and 16 of the annex to your testimony, indicating the underlying assumptions for those projections.

Also, I would appreciate being kept closely advised of the conclusions reached by the Working Group on International Investment as to its review of U.S. investment policies, the adequacy of CFIUS, and current Federal foreign investment data collection efforts.

III

In anticipation of a future subcommittee report on OPEC investments, we find it necessary to utilize certain portions of two Tab 2 document summaries furnished by Treasury to the subcommittee on July 14, 1981. First, from Document No. I-3, dated Fall 1977, in an appendix to the hearing record we want to publish three paragraphs beginning on page 3: "Disclosure....", continuing onto page 4. Next, from Document No. L-7, we want to publish the first full paragraph on page 1 on the document. Those are the only portions which we intend to publish. This notification is to give Treasury the opportunity to comment upon these portions of the documents, (to assure that the name of the countries involved are not revealed), as provided for in Mr. Thomas' July 14, 1981, letter to me.

IV

Next, on August 13, 1980, Treasury furnished to the subcommittee 13 Tab B (restricted use) documents which deal with Iranian assets in the U.S. In conversations between former Deputy Secretary Carswell and myself, Mr. Carswell indicated that these documents were sensitive because of the holding of the

American hostages, but that, upon their release, the documents would be less sensitive. Accordingly, we want to publish five Treasury/Iranian data documents: (1) 12/5/79 letter from Senator Church to Treasury, (2) Treasury's 12/17/79 response to Senator Church, (3) 11/14/79 memo to Mr. Widman from Jerry Newman, (4) a handwritten sheet about Iranian direct investment, and (5) 2/1/80 memo to Jerry Newman and Ida Mantel from Dirck Keyser. Subcommittee staff has already advised Russell Munk (OGC) of the need for these documents. Accordingly, we would like these documents released from the Tab B arrangement, in view of the changed circumstances under which they were furnished.

Please furnish (1) answers to the questions in part I, (2) the future projections in Part II, and (3) a response to my request in Part IV, no later than November 16, 1981, so that this material can be included in the hearing record. Contact Subcommittee Counsel Stephen R. McSpadden if there are any questions.

Sincerely,

Benjamin S. Rosenthal
Chairman

BSR:mv

Attachment

Inter-Office Memorandum

[x] ACTION [ ] BRIEFING [ ] INFORMATION

Date: January 10, 1980

For: Deputy Assistant Secretary Karlik

From: Dirck Keyser CMM

Subject: Foreign Assets Control's Interest in Market Watch

Dennis O'Connell, the acting chief counsel of Foreign Assets Control, called me yesterday to ask how Treasury could get early warning of sudden politically-motivated withdrawals of funds from U.S. banks such as that threatened by the Iranians on November 13. He wondered if there were any requirement or informal arrangements that banks report such transactions to us.

I told him that there are not now in force any requirements for such reporting of which I was aware. I suggested, however, that it is difficult for any such massive move to take place without disturbing the markets in some observable fashion which would be reported through the press (particularly such wire services as Reuters which give one hourly or even more frequent market reports) and informal market contacts of the Treasury and the Fed. I noted that we here in International Economic Analysis had once filled this role to some degree, but that the function seems to have been taken over by Jerry Newman's International Banking Office (IMB), where I have heard mention of daily market contacts. We had lost our Reuters to an Economic Policy budget cut, and our regular semi-annual reviews of the market had been done away with.

The elaboration of yet another mandatory reporting requirement would probably fly in the face of current Congressional thinking, I said, and explained that it would probably be cheaper and more efficient, as well as less burdensome, to assign someone the full-time role of market watch officer, and to subscribe to the regular Reuters ticker service. The history of intelligence shows that the greatest weakness lies in the field of analysis and dissemination, rather than collection, and I suggested that the appointment of such a watch officer could exploit the already existing plethora of information. Such an officer should make several market contacts a day in person or by telephone, as well as keeping abreast of press, ticker, and classified intelligence reports.

All of the above functions may already be carried out by Newman or the

	Initiator	Reviewer	Reviewer	Reviewer	Reviewer
Surname	Keyser				
Initials/Date	CMM / 1/10/80	/	/	/	/

OS F 10-01.2 (6-77) which replaces OS 3275 which may be used until stock is depleted.

Inter-Office Memorandum

☒ ACTION ☐ BRIEFING ☐ INFORMATION

Date: January 10, 1980

For: Deputy Assistant Secretary Karlik

From: Dirck Keyser CMM

Subject: Foreign Assets Control's Interest in Market Watch

Dennis O'Connell, the acting chief counsel of Foreign Assets Control, called me yesterday to ask how Treasury could get early warning of sudden politically-motivated withdrawals of funds from U.S. banks such as that threatened by the Iranians on November 13. He wondered if there were any requirement or informal arrangements that banks report such transactions to us.

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OS F 10-01.2 (8-77) which replaces OS 3275 which may be used until stock is depleted.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

November 16, 1981

Dear Mr. Rosenthal:

I am pleased to reply to your letter of November 2, which raised a number of additional questions to be answered for the hearing record of Assistant Secretary Leland's September 23 testimony before your Subcommittee, and the anticipated Subcommittee report on OPEC investments. My response follows the order in which you directed questions in your letter.

I

1. Treasury's response to recommendations of the Securities Industry Association, concerning possible steps to improve the foreign portfolio data collection efforts of the U.S. Government, is as follows:

Recommendation: The Treasury should clarify and publicize its guidelines concerning transactions executed on behalf of foreign investors. If policy makers are primarily concerned with the origin of portfolio funds, origin of the order should be reported on the basis of customer residence.

Response: Treasury agrees that it is important to convey clear and concise TIC S-Form reporting requirements to current and putative respondents, and to that end periodic attempts are made to identify potential reporters and inform them of the reporting requirements. By the end of this current calendar year, we plan to undertake an effort particularly aimed at potential nonbank reporters. The Treasury also issues from time to time supplementary reporting instructions to clarify particular reporting problem areas.

The S-Form instructions provide that a securities transaction order should be reported on the basis of customer residence, which is the address of record and the information generally available to a reporter. We recognize that the customer's residence may not be the same as that of the beneficial owner when transactions are conducted through foreign agents, nominee accounts, or trusts. Based on our instructions and experience we would expect the U.S. broker to attribute the purchase or sale of a security to the country from which he received the order.

Recommendation: Federal Reserve Bank of New York should play a more active role in reviewing S-Form data and could chart general trends in the value of transactions and departures from this trend.

Response: The International Reports Staff of the Federal Reserve Bank of New York has long-established procedures for closely monitoring the data on Form S. Staff members draw on a wide variety of information available to the Bank including information from market sources when they review and edit these reports. The International Reports Staff follows developments affecting the data and contacts individual reporters when large and unusual transactions or other suspected reporting problems occur.

Recommendation: The Treasury Department should institute more effective procedures for enforcing compliance from firms which may be unaware of their responsibility to file Form S reports.

Response: Efforts to improve compliance are continuing and varied. Both the Treasury and the Federal Reserve Bank of New York follow closely the financial press and various market reports for indications of specific brokers' activity. Non-reporting firms are contacted to make them aware of reporting requirements. Submissions by reporters are carefully screened. Following the Treasury benchmark survey of 1974 we were able to contact a large number of potential S Form respondents to ask them to review TIC reporting requirements and determine their reporting responsibility. We will use the results of the 1978 Foreign Portfolio Investment Survey to undertake again this type of compliance review.

Recommendation: Greater efforts should be made by reporting firms to distinguish between direct and portfolio investment. Individuals recording data on the S Form cannot realistically be expected to calculate the percentage of a given company's shares outstanding accounted for by each trade executed on behalf of a foreign customer. However, a level can be set above which investments could possibly be classified as direct and reported separately from the S Form.

Response: Direct investment is defined as ownership by one person, or an associated group, of 10 percent or more of an enterprise. Securities dealers acting as transactions agents for domestic or foreign principals are not always able to identify international direct investment activities, particularly where shares are acquired over a period of time. Form-S, therefore, captures some direct investment transactions. Efforts are made by both Treasury and Commerce to identify and reclassify such direct investment activities. Adjustments to both portfolio and direct investment data are reflected in the international investment statistics published by the Department of Commerce. These adjustments are cross-checked through benchmark survey efforts.

We agree with SIA's judgment that individuals recording data on Form-S cannot realistically be expected to calculate the percentage of a given company's shares outstanding that is accounted for by trades executed on behalf of individual customers.

Recommendation: The Treasury should institute reporting at regular intervals of the industry breakdown of transactions in U.S. corporate debt and equity instruments for selected U.S. industries by a number of randomly selected organizations.

Response: The Treasury disagrees with this recommendation on the grounds that it would not result in a meaningful compilation of foreign portfolio investment data and would entail increased reporting and analysis burdens and costs. Reporting such as that obtained by periodic benchmark surveys, including reporting by securities issuers, is generally required to survey adequately the extent of foreign participation in specific U.S. industries. The reporting of transactions with industry detail would not only impose an additional burden and cost on the private sector but also would strain resources currently available to Treasury to perform processing and editing required for the S Form.

A comparison of the 1974 and 1978 benchmark data suggests that the U.S. industry composition of foreign portfolio investment has remained relatively static over time. On the basis of these two surveys, we continue to believe that the periodic benchmark surveys adequately serve the need for an industry breakdown of foreign portfolio investment in U.S. marketable securities.

Recommendation: It would be worthwhile for Treasury to create a private sector task force to assist in setting up the next portfolio investment benchmark survey.

Response: In designing the next benchmark survey, we expect to utilize the Foreign Portfolio Investment Survey Advisory Committee--in effect a private sector task force--to assist in designing the survey questionnaire and in identifying possible questionnaire respondents.

2. Treasury has not created any new staff positions specifically intended to give an early warning of sudden, politically-motivated withdrawals of funds from U.S. banks such as was threatened by the Iranians. The Treasury has a "watch" office, which monitors intelligence reports, communications from the State Department and other U.S. Government agencies, and news reports on a 24-hour basis. This office was the organization within Treasury that received and passed on information that Iran might act in a manner contrary to U.S. national interests. In other offices, Treasury personnel monitor financial market activity on a continuing basis, as it directly relates to their responsibilities and expertise. They cover a broad range of developments that can affect U.S. national interests and maintain appropriate contacts with the financial and business community. Finally, in the event that a foreign investor threatened action detrimental to a U.S. financial institution, it is highly probable that the institution would itself alert officials in the Treasury Department or other appropriate U.S.G. agencies to this possibility, in an effort to obtain government assistance and protection on a timely basis.

3. You asked why there was a large difference between the Fed and Treasury figures for the cumulative unidentified amount of OPEC investible surplus worldwide, 1974-1980. On September 23, Treasury provided a figure of $57 billion compared to $24 billion estimated by the Fed, which includes the $8 billion for 1974-79 mentioned in your question. These Treasury and Fed figures for the discrepancy of estimates differ primarily because the Treasury has made a detailed estimate of investible cash surplus, which includes net borrowings by OPEC countries. The Fed does not prepare an estimate of investible cash surplus.

The Fed estimates the cumulative OPEC current account, inclusive of official transfers. Comparable Treasury and Federal Reserve estimates of the cumulative OPEC current account surplus from 1974-1980 actually are reasonably close -- $324 billion vs. $337 billion, a difference of $13 billion over a 7-year period (see page 4 of the Annex to Mr. Leland's statement).

Treasury estimates the cumulative investible surplus in order to estimate funds available for placement. The cumulative investible surplus consists of the OPEC current account after adjustments to exclude official transfers that otherwise reduce the current account ($357 3/4 billion), the lag in receipts (negative $21 1/4 billion), and net borrowing ($53 billion) by OPEC countries. The investible surplus of $389 1/2 billion compared to estimated placements of $332 1/2 billion results in a cumulative discrepancy of $57 billion, which may indicate some overestimation of investible surplus or underestimation of OPEC placements, as already discussed in the Annex.

Fed and Treasury estimates also differ because Fed figures for OPEC placements outside the United States are estimates prepared by the Bank of England. Differences between Bank of England and Treasury estimates were also discussed in the Annex.

4. The September 23 statement indicated that disclosure of OPEC investments by country would constitute unnecessary and counterproductive interference in the affairs of foreign investors. The present statutory and policy stance of maintaining confidentiality of the affairs of individual investors--public or private--is in our view a proper one, subject, of course, to compliance with U.S. law such as that governing reporting of large acquisitions of voting securities.

Direct investment by individual investors is disclosed to the public when they report to the Securities and Exchange Commission the acquisition of holdings in excess of five percent of the publicly-traded securities of a U.S. company. In addition the Department of Commerce's Office of International Investment (OII) collects and publishes public information on individual direct investment transactions. The SEC and OII Reports therefore provide the public with information about individual foreign acquisitions that may be significant for U.S. national interests.

On the other hand, direct investment data reported to the Bureau of Economic Analysis is kept confidential according to the requirements of the Bretton Woods Agreements Act and International Investment Survey Act. Thus BEA does not publish country-by-country investment data for all countries.

The CCEA Working Group on International Investment is currently reviewing the coverage obtained in BEA's surveys of direct investment, steps that might be needed to improve coverage, and the cost of improvements to the data -- all in a manner consistent with the requirements of the laws under which direct investment data are collected and disseminated. I would be glad to advise you when that review is complete.

CFIUS has never requested country-by-country investment data from BEA.

5. Treasury has no plans to publish in the Treasury Bulletin aggregate figures for OPEC investments in the United States because the Commerce Department is the agency that compiles comprehensive international investment information. The Bureau of Economic Analysis in Commerce publishes annual OPEC investment flows regularly in the March issue of the Survey of Current Business and provides additional information in subsequent quarterly or annual articles on international investment.

Treasury publishes in the Treasury Bulletin figures for portfolio investment as reported on Treasury's International capital reports. Most of these data are reported monthly and cover the bulk of oil exporters' investments in the United States.

II

You requested that Treasury furnish projections of the OPEC country surpluses for the next five years. As indicated in testimony on September 23, Treasury does not produce such a projection because we feel that they are of minimal practical value. Treasury only produces OPEC current account projections for the 1981-82 period and we have already provided our most recent estimates to the Subcommittee.

III

You also indicated that the Subcommmittee wishes to publish portions of two Tab 2 documents, I-3 and L-7. Treasury would strongly object to the publication of portions of the two Tab 2 documents, both of which are summaries of memoranda of conversation between high level Treasury and foreign government officials. Earlier this year, Assistant Secretary Leland personally reviewed the documents (including I-3 and L-7) made available under cover of Assistant Secretary Thomas' July 14, 1981, letter to you and specified that summaries of memoranda of conversation should be made available as Tab 2 rather than as Tab 1 documents.

In his July letter Assistant Secretary Thomas stated that the summaries of the documents enclosed with his letter were made available on the following understanding:

"The edited versions at Tab 1 may be published by the Subcommittee.

The edited versions at Tab 2 may be drawn upon by the Subcommittee in preparing its reports. We understand that Treasury will have an opportunity to comment upon those portions of draft reports which reflect information drawn from Tab 2 documents. This arrangement is similar to that which the Subcommittee worked out with the State Department some time ago. Also, the Tab 2 documents will not be shown or given to anyone other than the Subcommittee and its staff."

IV

You requested that five documents which deal with Iranian assets in the United States be released from the Tab B arrangement under which they were provided to the Subcommittee on a restricted basis. We have checked with staff of the Senate Foreign Relations Committee and have been informed that they have no objection to the release from the Tab B arrangement of the letter from Senator Church to Under Secretary Solomon. We also have no objections, and enclose herewith a copy of that letter for publication without the confidential markings and without the list of names of Treasury officials to whom it was circulated. Treasury has declassified the three classified Treasury documents, and we enclose herewith copies of those three documents as declassified which are released from the Tab B arrangements. The handwritten sheet about Iranian direct investment contains information received by Treasury from the Commerce Department. We are consulting with the Commerce Department about this document and expect to be able to respond to you about releasing it from the Tab B arrangements within a few days.

I hope you will find the above information helpful.

Sincerely,

Thomas Leddy

Thomas Leddy
Acting Assistant Secretary
(International Affairs)

The Honorable
Benjamin S. Rosenthal
House of Representatives
Washington, D.C. 20515

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JUL 16 1981
COMMERCE, CONSUMER AND
MONETARY AFFAIRS SUBCOMMITTEE

July 15, 1981

Mr. Benjamin S. Rosenthal, N.Y. Chairman
Ninety-Seventh Congress
Congress of the United States
House of Representatives
Commerce, Consumer, and Monetary Affairs
Subcommittee of the Committee on
Government Operations
Rayburn House Office Building, Room B-377
Washington, D.C. 20515

Dear Mr. Rosenthal:

In response to your letter dated June 30, 1981, in which you asked me to respond to a series of questions concerning potential problems surrounding the U.S. Government's monitoring of OPEC investment trends:

I. <u>Data Collection</u>

1) I believe that the SEC form 13d is an ineffectual way to monitor these foreign investments. My reasoning stems from the fact that foreign ownership of U.S. equity securities is purchased many times, through off-shore facilities, including, but not limited to Cayman or Jersey Island subsidiaries, Swiss bank accounts, or other vehicles. The 13d form, in my opinion, would not pick up these investments, because I do not believe that the investors themselves adhere to the definition of an association which would require the filing of a 13d by these investors. It is my opinion, although I have no direct knowledge of this, that foreign investors, which seemingly act independent of each other, may not be acting independently as would be defined by a close examination of their associations if a 13d issue were to be litigated. Many foreign investors do not feel a responsibility to report pursuant to a 13d or are ignorant of 13d requirements. It is my belief, although I have never had any involvement with the Securities and Exchange Commission in these matters, that the monitoring of 13d's comes to the fore only when there are blatant and open hostile takeovers. OPEC investors are not aggressive, open and hostile investors to management, but passive investors so there is no reason on the part of companies to launch extensive investigatory actions to see who the true beneficial owners of the securities are and thereby conclude whether or not a true association has been formed within the meaning of 13d. It is my opinion that the execution of orders to buy shares for OPEC investors are not to be aggressive open market purchasers, but merely to buy stock from Wall Street houses who show them blocks that have not

been fully placed. These orders are so designed so as to arouse the least market effect, short term, and from the point of view of long term mass market accumulation is the professional way to handle large orders.

Specifically, the problems with the United States Government's attempt to monitor foreign investment is that the 13d filing does not force a foreign person or foreign entity to disclose the true beneficial owner with any material force and effect. For example, under the new energy program up in Canada, which is expected to become law later this year, whereby Ottowa has offered to pay 80% of some of the exploration and development costs to oil companies that can prove that at least 65% of their shareholders are true Canadian owners, that grant declining in stages tied to ownership to a minimum of 35% for companies with less than 50% Canadian ownership have very severe rules to prove what Core ownership actually will be. For example, the way the Government is proposing to monitor this is that the Canadian Government wants to know who the true beneficial owners are rather than just the addresses of the shareholders. To be considered Canadian, an American can't simply have a post office box in Toronto. Although the regulations aren't law yet, the energy policy has been set out in detail and Prime Mininster Trudeau's Parlimentary majority makes thier eventual application practically certain. To police this Core ownership, companies defining their Core will be asked to eliminate all foreign addresses in the stockholder list and then test half the remaining shares focusing on individual holdings valued at $50,000 Canadian or more. These large shareholders will be asked who actually benefits from the holding. For example, in the case of a pension plan, the Government wants to know what percentage of beneficiaries are Canadian. If a big chunk ofstock is owned by another corporation, that company's core will also have to be calculated. Getting a response is important. A non-reply is assumed to be non-Canadian. Once 50% of these large shareholdings have been tested, the core calculation can be completed with the assumption that the ownership of the other 50% is the same. While such a test with respect to U.S. shareholdings may not necessarily have to be as difficult and cumbersome as exists in Canada where the Canadian Government will have substantial outlays to subsidize private exploration of the Arctic, there could be some mechanical formula worked out by the U.S. Government in connection with the reporting of a foreign ownership. Some random test, some affirmative duty by a corporation before it can transfer shares or pay dividends on these shares or give voting rights to these shares, to have the true ownership of the shares identified. This could be a condition to keeping a company's registration statement current with the SEC.

2) I can only surmise that there has not been an acceptable consensus in the Congress with respect to mechanics, or, for foreign policy or

economic policy reasons the Government may not want to press for further data collection. These reasons could include the desire to keep a strong dollar by having foreigners put money into this country. U.S. policy could favor large amounts of OPEC funds in the U.S.in semi-liquid forms to help cement relationships leading to what one would hope would be a more responsible pricing policy by OPEC as well as a more pro Western stance against Russian incursion into the area. It could be reasoned that, the greater the vested interest OPEC investors have in the U.S., the less likely they would be to do anything that would harm their investments. Over time one might also presume, that a favorable investment climate offered by the U.S. might induce OPEC investors to invest an ever increasing amount in more liquid forms of investment, and maybe, just maybe, they might adopt similar investment policies as existed by investors prior to the 1973-74 and 1979-80 leap in oil prices which created the greatest transfer of wealth this world has ever seen. Additional considerations preventing the administration from discouraging investment into the U.S. at this time is the need to bolster U.S. military forces after two decades of decay. This strategy includes trying to get some friendly OPEC countries like Saudi Arabia to purchase large amounts of arms, presumably to be used for defense, including any aggressive Soviet moves.

3). The answer to this question requires that a policy determination on the part of the U.S. Government with respect to the above mentioned issues which I feel unqualified to respond to.

II. Trends and Concerns

1) I believe the strategies that Middle East OPEC governments follow will naturally be a function of their supluses as well as their desire to have their political ends maximized. It seems clear from reading the newspapers that there doesn't necessarily seem to be unanimity with respect to the policies of the governments of the Middle East and certainly not necessarily unanimity between OPEC governments which include more than Middle East governments. However, notwithstanding the fact that governments may not agree specifically as to the oil price policy, what they may agree upon is a rational course of conduct for the maximization of assets they have.

As I see it these countries have three assets. The first asset is the remaining oil and gas in the ground to be preserved for future generations. The second asset is the conversion of the oil and gas that has been pumped out and converted into investment assets which have been invested outside their respective countries. The third asset that they have are their massive industrial plants, and other investments they have made like hospitals, airports etc., in their respective countries.

How are they going to invest the liquid assets out of their country? Since OPEC surpluses have been running in the hundreds of billions of dollars, they clearly represent the largest concentration of capital in the world today. While there is no specific unanimity with respect to the entire pool of capital, there clearly could be some close association or camraderie with respect to the investments of a good portion of the capital. As a money manager, if I were running their investments, I would seek a strategy that would be dictated by a need for liquidity and safety as well as the ability to invest large amounts without public notice. So for example, that is a policy they have followed by using Government instruments of short duration up to five years in maturity. This market is highly liquid in the event they wish to withdraw their funds for policy reasons or economic reasons. However this market vehicle does not protect them from the inflation. They may be willing to accept this thesis on the theory that high inflation has led U.S. economic policy to be quite restrictive and thus keeping short term rates high with accompanying strength in the U.S. dollar. But eventually more and more money will seek a more permanent home and as they seek debt instruments over five year maturities they will lose liquidity and also invest in an instrument that is more negatively suseptible to the ravages of the underlying inflation rate - namely long term bonds. Since their own oil pricing policy has a lot of impact on the underlying inflation rate they may be reluctant to plunge into long term bonds in any meaningful degree since raising oil prices, while increasing their wealth in one respect, will hurt long term bond prices, thus decreasing the value of their investment.

2) I believe that within the last several years, major investments in the areas of common stock in major corporations including banks and oil companies have been made by these foreign governments and/or private individuals who, while they are private individuals, are very closely associated with the governments because of the structure of the societies involved. I suspect, although I have no direct knowledge of this, that there have been instances where upon close scrutiny, a good case can be made that their 13d filings should have been but because of the conduct vehicles of investment and the lack of surveillance perhaps even consciously by the companies involved, and since these are not litigated situations, these investments have gone unnoticed, and therefore the issue has not surfaced. Therefore, I think the investment strategies that I foresee are for substantial increases in investment in U.S. securities considering the fact that if you add up the market value of the equity securities of the United States that are in public hands along with all of the equity securities in Japan, Germany, France the UK, Hong Kong and several other smaller countries, it's clear that the market value of the U.S. equities accounts for half of that of the world. But more important, the liquidity factor or the velocity turnover in terms of what is in public hands and what is capable of being purchased makes the United States an extraordinarily attractive market, although Japan has high velocity as well, but the

market is less than a third of that of the United States with respect to the capacity to invest equity investments.

Other than equity investments, I can envision a substantial increase in the amount of private placements that foreign OPEC governments, or OPEC governmental agencies, as for example, the Kuwaiti Investment Trust, will be willing to make with U.S. corporations at rates which are extremely favorable. This naturally ingratiates themselves in the treasurers' offices, since it would be very nice for a treasurer to do a private placement with SAMA or the Kuwaiti Investment Trust at a hundred basis points or so below which they would be able to make a private placement with the Prudential Insurance Company. The cost to SAMA is insignificant. The gain is very substantial because it opens the door for further business dealings including additional equity investments, joint ventures and a more sympathetic feeling by these corporations that they have a deep pocket waiting in the wings.

I believe that a lot of money will be made by a lot of U.S. and foreign people in the recycling of petrodollars and that while this may be a good thing for a few, the consequences for the majority in this country is dubious. The longer that time passes and the more people that get involved in the recycling of petrodollars into the U.S., the more difficult it will be to reverse the trend. For one thing, given the multi billions of dollars we are talking about, the easier it is for OPEC agencies to buy good U.S. law firms and public relations firms to represent their interest. Additionally, as OPEC gets closer with major corporations whether through stock ownership or private placements, the more these corporations will lobby for continued acceptance of Middle East OPEC by the Establishment. It is my opinion that over the intermediate term, if this trend is not halted or even reversed, that there will be a substantial loss of sovereignty in this country which as a citizen, I feel is harmful. While I feel more money might be made short term, through policies encouraging these investments, the long term may produce results cannot foresee today with consequences we might not find acceptable tomorrow and limited ability to correct those consequences since by then the Establishment will already have been purchased.

3) I do not foresee the U.S. finding itself in a position like Canada at any time in the foreseeable future. While I am not an expert on the history of development of foreign investment in Canada, it seems to me that the needs for capital from outside sources to develop the resources of the U.S. are substantially less

than the situation which existed in Canadian history. Finally, even if there were such a need, I still have the confidence that as a democracy, while we do not respond as quickly were the United States to be a dictatorship, there would be sufficient ground swell to prevent the de-Americanization of America.

Sincerely,

Stephen A. Royce

Stephen A. Royce

SAR:ll

cc: Stephen R. McSpadden,
Commerce, Consumer and Monetary
Affairs Subcommittee
Congress of the United States
House of Representatives

PETRO- DOLLAR DEPOSITS

THE CONSEQUENCES OF THEIR INFLUENCE
ON THE UNITED STATES ECONOMY

SUBMITTED BY:

DANIEL A. O'CONNELL

TO

THE COMMERCE, CONSUMER AND MONETARY AFFAIRS
SUBCOMMITTEE, OF THE COMMITTEE ON
GOVERNMENT OPERATIONS

HOUSE OF REPRESENTATIVES

86-722 O - 82 - 21

Despite any rhetoric to the contrary, the economy of the United States will begin to experience the first phase of what will become an economic contraction more severe an devastating than the one undergone in the early thirties.

The possibility of avoiding this catastrophe seems very remote. Quite frankly, given the tendency of decision makers to focus their attention on symptoms rather than causes, and the actions taken in that vein, actually serve to accelerate the economy towards this day of reckoning.

The purpose of this report is to identify the basis for such a bleak prediction, and, in identifying the problem, offer those who are in a decision making position the opportunity to focus on the causes and not the symptoms.

It is very clear that any attempt to change the course of events will require daring and decisive action. Such action may only reduce the devastation that is imminent, but even for that, the risk is worthwhile.

First of all, let me dispel a myth or two. The myth of government printing presses creating vast quantities of currency is just that, a myth. The supply of printed and coined money has been relatively stable in its growth. Chart #A tracks the growth of currency supplies in the United States (see Currency). The next myth is that of the growth of the M1 measure of money supplies (see chart A- M1-B). This measure includes currency, demand deposits in commercial banks, and checkable deposits in other institutions. Though the Federal Reserve has made much over this supply measure, it too has been relatively stable over the past two decades. As you look at Chart A, you will note a tracking for a measure called "L". "L" is the grand total of money supplies. It includes: overnight re-purchase agreements, term and overnight Euro-dollars, money market mutual fund shares, savings and small time deposits, large time deposits, savings bonds, short term Treasury securities, bankers' acceptances and commercial paper. It is the total asset base against which credit is extended.

As you can see, this measure was tracking on a relatively stable course and its growth, until 1970, was essentially in line with the economy. Its growth resulting from the normal function of the reserve system that is designed to generate monies for economic expansion, relative to the general growth of the entire economy. As you see, in 1970, the "L" factor began to depart radically from its previous course. The extension of "L" shown as ("L" normal) is the track that one could reasonably have expected. But instead, we find that "L" began to rise and to rise dramatically. The "bubble" that is still growing is the "bubble" that threatens this economic system. There is only one way for this "bubble" to have developed into its exaggerated shape.

A large volume of dollars had to be deposited into the banking system. Those deposits then began to generate more dollars as they moved from deposit -to-loan-todeposit-to-loan and so on. As you know, $1000 deposited in a time deposit, after some 50 transactions of loans and re-deposits into time deposits, creates over $18,000 in loans and $18,000 in deposits (at a 5% reserve rate). The average time sequence is about 32 months. However, with the higher velocity attained through the use of computer technology, this effect is now much quicker. Assuming a mixture of transactions, involving time deposits and demand deposits, which function with a 10% reserve rate, $1000, in a matter of 24 months, can conservatively create $10,000 in loans and $10,000 in deposited funds, none of which requires any printing of currency. The "bubble" That began to grow in 1970 was created through this process.

From where did the deposited dollars come that grew into this "bubble"? Those dollars were OPEC petro-dollar deposits. They are depicted as "OPEC DOLLAR DEPOSIT ACCUMULATION" on Chart A. Their dollar generation, within the banking system, is depicted by the graph called "DOLLAR GENERATION AND ACCUMULATION". They are the very dollars that have served as the inflator of the "bubble" of the "L" measure.

Yes, it is the OPEC deposits flowing into our system that have generated the radical increase of the "L" measure and likewise, have generated the lendable funds that have made possible the exaggerated growth of the debt structure of this economy.

Chart B tracks the growth of debt in the United States. The growth of corporate debt, individual and non-corporate debt and the federal debt, have all demonstrated the same aberrational tendencies as the "L" measure on Chart A. The fact is that both are related. The "L" measure reflects the deposit side of the money generation. The debt growth reflects the loan side of the generation process.

How many dollars have been deposited into financial instruments of the United States economy as a result of the oil imports from OPEC?

Below is a running tally of oil imports into the United States from the OPEC countries of Algeria, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates and Oman, based on average prices for the year of reporting.

TABLE I

Year	Millions of Barrels	Average Price Per Barrel	Millions of Dollars
1970	124	1.70	$ 210.0
1971	221	2.20	$ 486.0
1972	337	2.20	$ 829.4
1973	624	3.37(2.20)(5.12)	$ 2,102.8
1974	786	11.65	$ 9,156.9
1975	996	11.65	$ 11,603.4
1976	1546	11.65	$ 18,010.9
1977	1927	11.65	$ 22,449.5
1978	1846	11.65	$ 21,505.9
1979	1790	19.00	$ 34,010.0
1980	1386	30.00	$ 41,574.0
* 1981	1157	30.00	$ 34,710.0
		TOTAL	$196,648.1

* (projected on daily imports)
(U.S. Bureau of Mines) (U.S. Dept. of Commerce)
(U.S. Dept. of Energy)

TABLE II

Generated Dollar Accumulation, including deposits. (In billions of $)

1971	$ 1.6	1978	$ 621.0
1972	$ 6.0	1979	$ 760.0
1973	$ 14.7	1980	$ 972.0
1974	$ 38.0	1981	$1,350.0
1975	$ 109.0	1982	$1,758.0
1976	$ 231.0		
1977	$ 400.0		

Of that $196.6 billion, almost 50% of it has entered the U.S. banking system in the last 36 months and is just now beginning to make its presence known, continuing to drive the "bubble" into an even steeper and more exaggerated shape.

Chart C depicts the OPEC deposits and their dollar generation on a level base. The two periods of inflation that have been popularized in the past several years were the inflations of 1974-75 and 1979-80. A myth has been created by some, that alleges that these inflations were a simultaneous effect of the oil price increase of those two periods. I call this a myth because what in fact caused the inflation of 1974-75 was the result of the increase in the price of imported oil in 1971, the increase in quantities imported [see Table I above] and the depositing of these dollars into the system. By 1974-75, these deposits had, through the function of the reserve system, generated the first phase of the aberration of the "L" measure. The inflation of 1974-75 was the effect of the process begun in 1971.

The inflation of 1979-80 and the inflationary tendencies that preceeded it, though not double digit, was the result of the surge in dollar deposits as a result of the price and quantity increases of 1973-74 and the continuing generation of dollars as they began their travel through the deposit-loan process of the banking system. The increases in dollar deposits resulting from price/quantity increases effect the inflation rates only AFTER they have been through the system. The fact is that the price increases of 1979-80, and the resulting dollar deposits, are just now beginning to blossom. Remember, up to now, we have only witnessed half of the action. In the past 34 months, another $102 billion has been ADDED to that 8 year accumulation. If you believed that 14% inflation was tough, try 25% to 35% in 1982 and 1983 when the latest $102 billion has its matured effect on the U.S. economy!

The problem with that rate of inflation is that the average American family will not survive. Due to the inflation of the past decade, and the increase in debt liability by the average American, nearly 88% of after tax dollars are committed to debt service and to meeting the costs of living. The average family has a 12% margin of safety. However, given the lag time for wage and adjustments and the immediacy of cost increases, this margin even with a 10% rate of inflation, tends to shrink disproportionately. An inflation of 15% to 20% would virtually eliminate that margin and overnight, people would begin to renege on servicing their debts. Once that occurs, the initial phase of contraction will begin. The "bubble" will begin to leak and deflate. However, those whose deposited dollars become irretrievable because the system is not functioning in reverse as it functioned in its forward motion. Remember, if deposits provide loans, then repayment of loans must occur at some point to refund deposited dollars, if they are requested. Inability to service debts makes it impossible to refund deposits. The intelligent depositor removes his funds while they are refundable and moves into another position until the system reaches equilibrium. The OPEC depositors could, overnight, via computer retrieval, force the economy into sudden contraction until it reached the levels of "L" normal on Chart A. At that point, they would be in a most enviable position. They could, in effect, buy the country at "a dime on the dollar". This scenario is not hypothetical, it is a real and viable situation that is not only possible, but very profitable.

The important factor is that the contraction of this economy is one that can be initieted at any time, without anyone's knowledge, thanks to the retrieval systems available to such sophisticated depositors as the OPEC countries and the Saudi Arabian Monetary Authority.

Whether it is the inability of Americans to pay their debts in 24 months because of high inflation, OR a recessionary economy, OR the austerity measures of the central government, OR the loss of face by Saudi Arabia amongst the Arab partners as a result of the AWAC's decision, OR because Shiite Islamics in the oil fields of the Eastern province of Saudi Arabia decide to follow Khomeni's advice and overthrow the "decadent heretical" Sunni overlords, the Saud family; WHATEVER the excuse, whatever the circumstances, those deposits, all $196.6 billion and their economic influence, are in the hands of someone else. The economy of the United States depends on those depositors and their whims. They cannot lose. Only we lose, and with it, our dreams and hopes.

What is most unfortunate is that the central banking authority, the Federal Reserve, has either consciously or unconsciously, evaded the real problem and instead, has attempted a symptomatic treatment that is merely increasing the cost of lendable funds. The only result of this simplistic and mis-guided policy is to assure further enhancement of the rate of inflation, through the passing on of money costs to consumers, and in restricting the growth of economic activity by preventing new enterprise through the same high costs of money.

In addition, this policy has turned the American investor and saver into a gambler, gambling on debt. No longer are investors seeking to invest with the hope of seeing a venture grow and return dividends and profits. Instead, they offer their dollars to the highest bidder, hoping to survive long enough to pay them back. They speculate on debt and ignore the future. This is the real result of the Federal Reserve's policy. We have become a nation of greedy lenders and borrowers. No longer are we investors and builders. In the late twenties, and again in the sixties, people bet on the prices of over-valued equities. This time, and with the same vehicle of the sixties, the mutual fund, they are betting on debt and the ability of the borrower to repay. This time, they call it a money market mutual fund, though most people only use the term "money market". The Federal Reserve classifies the multi-billion dollar speculation on debt as a mutual fund, and those who place money in these funds hold shares; no different than those invested in the earlier mutual funds. That speculative position now totals over $150 billion. Inflation MUST continue for the continued profitability of the investment. No different than the need for equities to continue to grow in price during the earlier mutual fund speculation of the 60's and the even earlier stock speculation of the 20's. One only needs to remember the call market of that era. The very policies tauted as solutions have only exacerbated the situation making any contraction even more disastrous.

No, there is no conspiracy. It is simply the inability of those who are decision makers to deal with a situation that was not in the textbooks. In a classical trading situation, the importer paid the exporter. But the exporter turned around and purchased from the importer. This time, the exporter had no demand for equal or near equal purchases from the importer. Instead, he deposited the dollars and then when needed, secured loans in the marketplace to finance what purchases that were made, thereby leaving the deposited dollar intact. This is why the general notion is that OPEC deposits are not as great as they are. The aurhorities have made the mistake of subtracting the purchases made from the deposits made, but what they failed to realize is that the purchases were financed with the generated dollars and not with the deposited dollars. Again, a non-text book situation and with that, a failure to understand what was really happening. OPEC did not reduce its deposited dollars. It merely borrowed some of the 10 extra dollars their deposits had created. The really sad part of this entire situation is that because of the Federal Reserve's misguided, symptomatic solutions, hundreds of thousands of Americans have placed their life savings into not only a volatile and speculative position, but that even their government, which they trust despite their occasional complaints, has no real control over the security of their investment, despite assurances to the contrary; most particularly certificates of deposit and other allegedly safe instrument of savings.

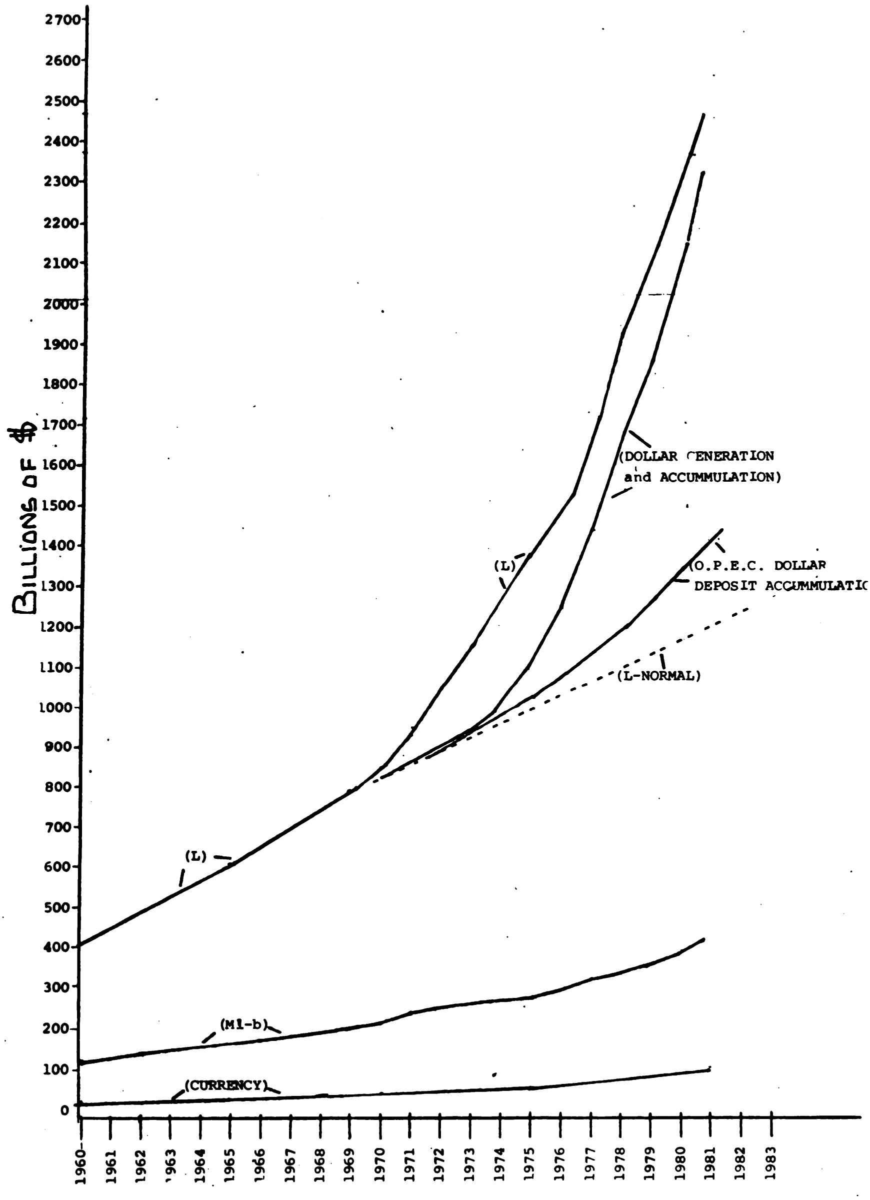
Even the small saver stands to lose. The effects of inflation will cause withdrawl of those funds to meet expenses, which in turn, forces the retrieval of loaned funds. This begins to force contraction in the same fashion as an OPEC withdrawl would. However, the $1 trillion saved by the people and placed in C.D.'s and savings accounts are not as easily retrieved. Given the factors that now exist, and the rules regulating withdrawls that apply to our own citizens, these savers will find themselves unable to not only withdraw their funds, but due to the debt structure that has been created, find that any retrieved will only represent about 15% of their savings. Even more critical is that if they wished to convert their entire saved dollars to cash, they would have to settle for 10¢ on every dollar, assuming that every piece of printed or minted money could be gathered together for the transactions. All OPEC has to do is to initiate an over-night computer retrieval, while American citizens wait in line hoping to get what they can from what they believed to be theirs. Twenty minutes of computer time could initiate the contraction that would prevent the service of debt and would make their savings nearly worthless, since those dollars were loaned in the hope that they would be repaid with interest.

The Federal Reserve is not alone in its inability to deal with this unique situation. I believe that if inquiry were made, it would reveal that many bankers in this country, believing that interest rates would fall to earlier levels, used six month certificates of deposit dollars to fund 20 and 30 year mortgages. Assuming that they could afford several roll-over losses in the beginning, making up the difference over the length of the contract, but only if interest rates dropped. There are banks in the Unites States that will find themselves paying holders of C.D.'s twice the dollars that the mortgages are generating. Not only will the banks lose money, but the holders of the C.D.'s will find that they are not able to recapture their funds, if too many of them wish to do so. The inability to deal with the petro-dollar deposits and their effects is not unique to any one sector of the financial community and therein is the real cause for concern. There are solutions and as I said earlier, they require bold and daring action. But if the action is not taken, the people of the United States and their leaders will most certainly become even more helpless and within months, will begin to suffer the first effects of the contraction that will occur. The decision is really whether we wish to have our destiny determined by OPEC or if we want to assume responsibility for our own future.

* * * * * * * *NOTE * * * * * * * * * * *

The argument has been made that OPEC would be forced to re-deposit any withdrawls and that the U.S. banking system would regain equilibrium as those re-deposited dollars returned from those new deposit locations.

This is not a valid argument, simply because OPEC can deposit those withdrawls into the Saudi Arabian Monetary authority and literally sit on them until the "Bubble" is flat. At that time, they could then re-enter the U.S. market acting as "lender of last resort" and make any deal they wish to make.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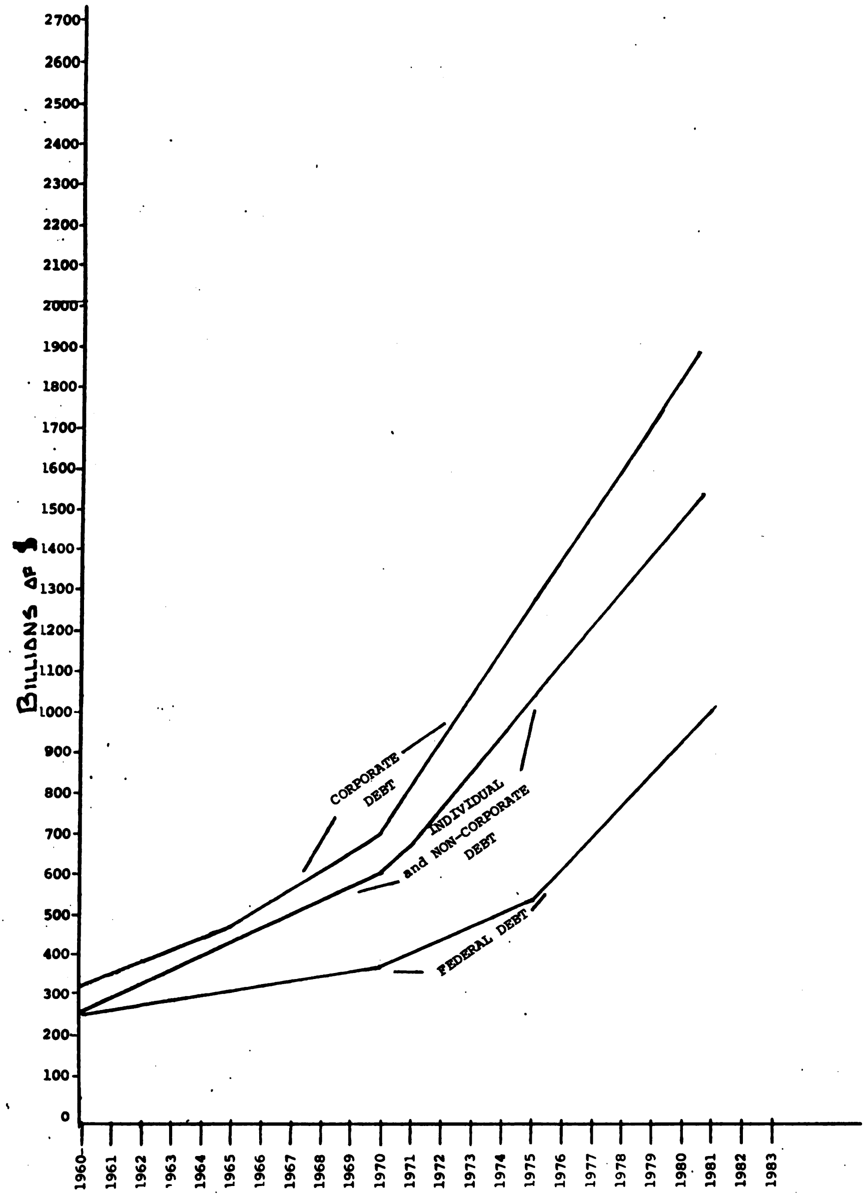
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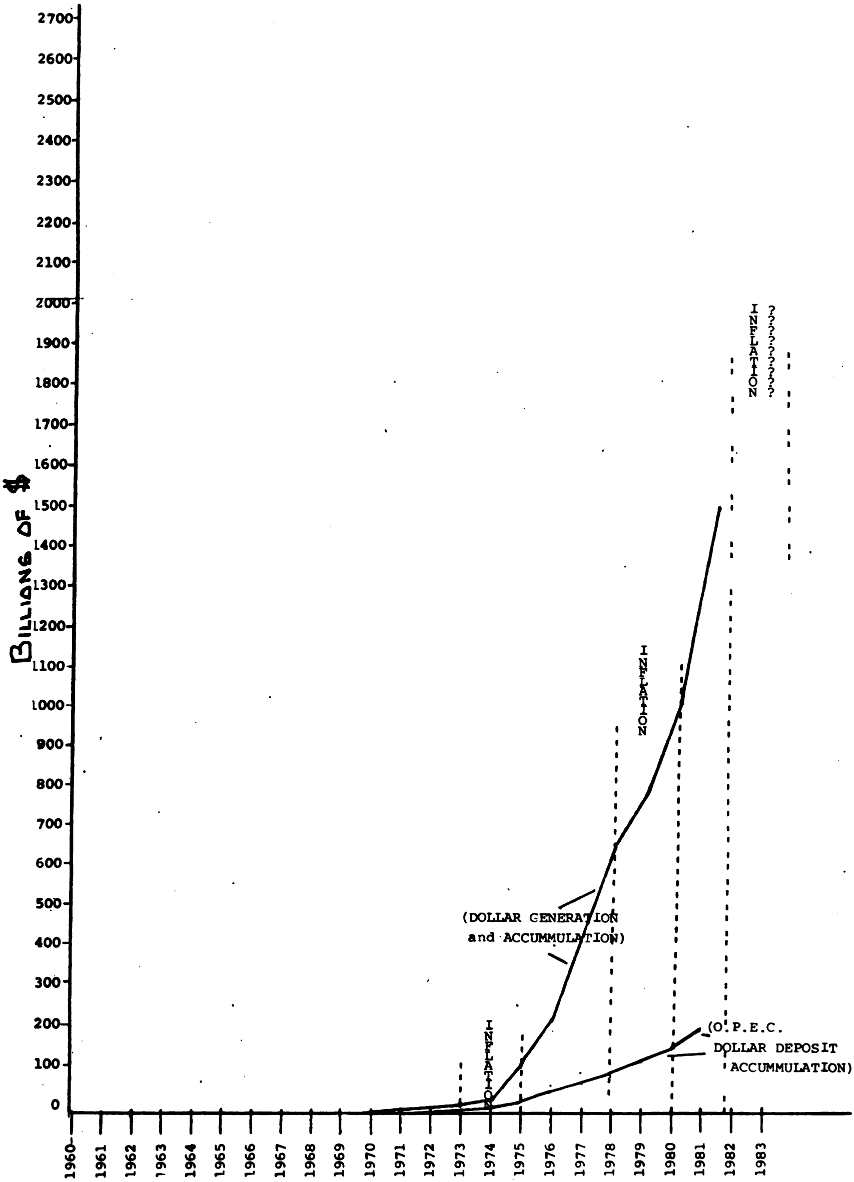
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C

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CONGRESSMAN BEN ROSENTHAL
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September 20, 1981

Chairman Benj. S. Rosenthal,
Subcommittee on Commerce, Consumer,
and Monetary Affairs, of the
House Committee On Government Operations
U.S. House of Representatives
House Office Bldg.
Washington, D.C.

Re: KUWAIT-QUATAR and SAUDI ARABIAN INVESTMENTS IN THE U.S.

Dear Chairman Rosenthal:

In 1974 our mysterious and elusive late client, Howard Hughes, decided to go into offshore oil exploration in the Middle East, and had talks with the Emir of Kuwait relative to doing so off the coast of the Emirates of Kuwait and Quatar, which are united in the sense of having a common foreign policy and economic establishments under the two Emirs, who are from the same family.

The Emir of Kuwait asked Howard Hughes how they should best invest the oil incomes they had to invest, over and above domestic needs. It was reconed to be some 3 billion dollars a month. Hughes said he would try and arrange for me to set up an investment banking Board of Consultants headed by myself under the Tuttle law firm's egis to pass on what should be invested in, and what should not.

An emissary and close associate of H.H. came to explain all this to me, and, I set up the Board of Consultants, as reflected down the left margin of this letterhead.

Things got very complicated, to say the least. We met sometimes twice, sometimes once, a week, at Washington, and sometimes almost daily, for a year. We formed an investment banking corporation with Attny. Tuttle and myself and our Consultant Board Members as the owners. During the fiscal year 1974-75 we processed 201 applications for investment of sums ranging from $5,000,000 to $200,000,000 each. Perhaps we were overly conservative, for out of the 201 packages, which had already been screened by our executive secretary, we had interest in possibly approving 3. Of those three, due to no fault of our own two ended in major scandals, and the third was not sufficiently far along in planning to act on. In the one scandal a Deputy U.S. Agency head had been evidently bribed by the person who brought the package to us, a retired U.S. Army Col. and legal officer practicing law in Virginia. Headlines! The other was even worse, or greater in scope. The Teamsters Pension Fund wanted to sell us first one, then two , then 101 resort hotels right accross the sun-belt from Florida to Arizona and California which they held inflated mortgages on and had foreclosed on. We were very interested, in first the one, then the second, then all 101 hotels; however, while negotiations were being finalized with the Teamsters Pension Fund, the Justice Dept. discovered that the ballooned mortgages and other fraudulent devices to pillage the pension fund had left it pilfered of some $900,000,000, and froze its activities and put a keeper on it, and indicted its directors.

Page 2.. Chairman Benj. S. Rosenthal, House Govt. Operations Committee, Subcommittee on Commerce, Consumer, and Monetary Affairs.

Add to this that the U.S. intelligence community, and the Dept. of State, both wanted to use our group as a cover and data pipeline on international financial transactions, which finally I approved as Chairman of our group, and you can see things were a bit hectic. I had decided the operation might as well be useful for intelligence and State, and carry on with its processing of investment packages; but, I had come to the conclusion there were insufficient good ones available to begin to invest three billion dollars a month, plus a big backlong on hand; and, I evolved another plan of operations for our clients which I intended to reccomend, which was fully sufficient to the task. So, Gen. Larry Fuller, U.S.A., and until then Army military intelligence commander, was taken onto our Board of Consultants, and went flying around here and there keeping tabs on what was going on in South America and Africa finance-wise of sufficient size to be of strategic importance to the U.S. And, our Special Legal Counsel, who had long Senate and State Dept. ties, discussed all pertinent data on a case by case basis, as it came to our attention, with the appropriate officers at State.

Also, at this time, the Saudis wanted counsel. I might say that from earlier times when I was an advisor to Presidents Truman and then Eisenhower, and Special Counsel to the Chairman of the Senate Foreign Relations Committee, that the Saudis from King Ibn Saud down had developed a high respect for me, though I never really did anything for them except suggest Ibn Saud get medical attention at the best U.S. medical centers. (Which he did.)

I arranged for our packages to be turned over to a lesser investment banking set-up headed by Robert Allen, veteran Presidential advisor and intelligence consultant, and Ambassador at Large; and, I advised the Emirs of Kuwait and Quatar, and the Oil Minister of Saudi Arabia, that that they should invest the surplusses of their national treasuries in (a) high interest yielding U.S. Treasury notes, (b) Blue Chip Stocks, and (c) large real estate parcels in the periphery of growing booming areas. I suggested such firms as Solomon Bros. in NY should be retained to advise them, and such outfits as Citicorp be their fiscal agents in U.S.

I understand, Mr. Chairman, that they have followed that advice ever since. And moreover that their Arab oil producing fellow nations not privy to that counsel suffered immense losses runing to 80% and 90% of their investments, for a time, until having learned that hard way they followed the example of the Kuwaitis and Saudis as outlined.

The figures so far available to your committee I do not believe to be accurate. There are no doubt in excess of $200 billion Arab oil dollars invested in the U.S., and another $100 billion or more in Europe.

Having said that, let me quickly add that I think it is a very good thing. I suggest we would now be having a depression here in the U.S. if that were not true. The oil drain in dollars is returned in investment

Page 3.. Chairman Benj. S. Rosenthal, House Govt. Operations Committee, Subcommittee on Commerce, Consumer, and Monetary Affairs.

If this inflow of petro-dollars should stop I think we would have instant depression. If the Arabs should draw down suddenly on their investments for domestic or strategic purposes, I think we would have dis-location of the economy of serious proportions. I see the responsibility of your committee to be to study these matters, consider every angle carefully, and come up with a Foreign Exchange and Control Bill to protect the national interest of the United States, and to at the same time encourage the continued investment of Arab petro-dollars into our economy. Both aspects are, at this time, altogether vital!

The 1975 winter cold snap of some 40 days at Washington got to me with flu going into pnemonia, and I headed for Florida sunshine and then the golden iles of Georgia, and then home to California to deal with the more regular cases of the letterhead law firm in which I head up management, research, and investigations. So, while I will not be in Washington for your hearings, I thought I would submit the above data and background and viewpoint to perhaps be of some substantial benefit to the deliberations of your committee as it considers there these very important questions affecting vitally our national interests and policy.

Yours Cordially,

David Earle Jordan

David Earle Jordan

DEJ:wp

APPENDIX 2.—MATERIAL ON (1) THE NATURE AND EXTENT OF OPEC COUNTRY SURPLUSES AND INVESTMENTS AND (2) OPEC COUNTRY INVESTMENT STRATEGIES AND POSITIONS

A. MIDDLE EAST OPEC COUNTRY, SURPLUSES, INVESTMENTS, MONETARY ROLES, AND FINANCIAL STRATEGIES

International Monetary Role

The Persian Gulf oil producers' position and interest in the international monetary system have increased since the winter of 1973-74, when oil prices were quadrupled. As a group, they have been unable to spend on additional imports as much as they have earned from increased export earnings. The resulting financial surpluses have substantially increased their holdings of international reserves. Saudi Arabia, for example, had official reserve holdings of $3.2 billion at end-73 and $21 billion at the end of the third quarter in 1975. (This is according to IMF published statistics which depend on national reporting that in this case probably understates total holdings.)

Some of the Persian Gulf states have the lowest absorptive capacity for imports among the oil producing nations. With the exception of Iran and Iraq, they are expected to continue to accumulate wealth in the form of foreign assets over the next decade, though at a declining rate. Their collective financial holdings will therefore be substantial into at least the mid-1980's, although increasingly concentrated in the low-absorbers -- Saudi Arabia, Kuwait and the United Arab Emirates.

National influence in international monetary affairs is only in part a function of a country's holdings of official reserves. There are numerous other factors which may also play a determining role, including: (a) the relative size of a country's economy and external trade; (b) use of a country's currency for transacting trade, maintaining reserves and intervening on foreign exchange markets; and (c) provision of international financial services through the country's banking system and capital market. Influence may also derive from a country's traditional role and financial standing or other historical factors quite apart from a country's real relative economic strength.

In this context, the positions of the Persian Gulf oil producers with respect to these factors have collectively increased over the last two years, which in turn relates to the increased importance of oil in world trade. On an individual basis, Saudi Arabia and Iran have been the biggest gainers (in that order) in terms of the absolute size of their increased financial assets. At some point in the near future, the United Arab Emirates will probably surpass Iran in terms of the annual buildup of official

[Subcommittee note.—This is a Treasury position paper.]

foreign exchange reserves, because of the U.A.E.'s large petroleum reserves and low capacity (unlike more populous Iran) to absorb imports. Iran, on the other hand, will continue to have large overseas investments and a large foreign trade sector.

The growing position of these countries in the international monetary system was recognized by the Interim Committee of the International Monetary Fund within the framework of the agreement to increase IMF quotas by 33.6 percent. On the expectation that their improved position would soon be reflected in data used in the quota calculations, the Committee agreed that the collective quota share of the major oil exporting nations should be doubled The collective voting power of the Persian Gulf states will approximately double from 2.3 percent to 4.8 percent of the total. (This was agreed to at Jamaica in January 1976, but will only become effective after ratification of the revised IMF Articles by the majority required for implementation.)

Since major decisions of the Fund under the revised Articles of Agreement can be vetoed by any group of countries (or by any single country) with 15 percent of the voting power, the increased collective vote of the Persian Gulf states is alone less than sufficient to veto key IMF decisions, but it does add to their potential decision-making influence in the IMF and it increases their weight within potential coalitions among non-industrial countries. (Note: One might also argue that the voting power of individual Persian Gulf states in the Fund underestimates their full power because by being large providers of assistance to some other Muslim countries such as Egypt and Pakistan, they gain influence with these countries.)

The Persian Gulf oil producers percent share of total quotas in the IMF rose as follows:

	Present Quotas (Percent)	New Quotas (Percent)
Iran	.66	1.69
Saudi Arabia	.46	1.54
Iraq	.37	.36
Kuwait	.22	.60
Qatar	.07	.10
UAE	.05	.31
Oman	.02	.05
Bahrain	.03	.05
	1.88	4.70

With the following increases in voting share:

	Present Votes	New Votes
Iran	.67	1.62
Saudi Arabia	.49	1.48
Iraq	.41	.39
Kuwait	.28	.62
Qatar	.14	.15
UAE	.12	.34
Oman	.10	.11
Bahrain	.11	.11
	2.32	4.82

A country may exercise influence in financial markets through changes in the level and distribution of its financial assets as well as through its voting power in the IMF or its participation in special transactions with the Fund, such as loans to the oil facility. However, in both areas of the international financial system (public -- at the IMF -- and private -- in the market place) the surplus Persian Gulf oil producers have thus far behaved with circumspection. (See Investment section below). Actions in both areas can affect the stability of the system and the fact that the Persian Gulf states have avoided destabilizing or irresponsible behavior in both would seem to indicate they realize how much of a stake in the system they have. Being unable to absorb all of their new wealth immediately through increased imports, they rely on a stable and well working international financial system in which to store wealth and try to increase (or at least maintain) its real purchasing power, pending its future use to import goods and services. But past behavior may not describe future behavior. A radical change of regime, for example, in Saudi Arabia, might bring to power leaders who would be willing to sacrifice financial wealth, even on a large scale, for some perceived political gain or in retaliation for a perceived wrong. Given the large, still fairly liquid foreign investments of some of these Persian Gulf states, the potential for their inflicting temporary shocks to the system does exist, such as through a rapid switch in funds on a large scale from London to New York. Such action would be highly costly to the countries using such a weapon (foreign exchange transaction losses, possible retaliatory confiscation, freezing of assets, etc.) and the system as a whole should be able to adjust fairly quickly through offsetting measures by cooperating monetary and financial authorities in the industrial nations.

3/17/76

The Wall Street Journal, February 10, 1980

Arab Oil Producers Are Advised to Invest In Land and Industry

Special to THE WALL STREET JOURNAL

LONDON—Arab oil-producing countries gradually should move most of their foreign assets from financial investments into such assets as holdings in companies and real estate, Hikmat Nuwayhid, banking and finance manager for the Industrial Bank of Kuwait, says.

Writing in the Organization of Arab Petroleum Exporting Countries Bulletin, Mr. Nuwayhid says that 87.7% of OAPEC's investments are in financial instruments and only 12.3% in other assets. He used figures showing how funds totaling $236 billion, accumulated between 1974 and 1979, were invested.

Mr. Nuwayhid estimates that at the end of 1980, the net foreign assets of OAPEC countries totaled $275 billion, and that this will rise to $355 billion by the end of the current year. Of the $355 billion, Saudi Arabia is expected to account for $150 billion, Kuwait for $84 billion, Iraq for $52 billion, Libya for $35 billion and the United Arab Emirates for $34 billion.

The Kuwaiti banker suggests that to protect their investments from inflation and to achieve a wider country and currency diversification, OAPEC countries should switch as much as 60% of their accumulated net foreign assets and their annual surpluses into companies and real estate, keeping up to 40% in financial instruments. He suggests this be done over 10 to 15 years.

He also suggests that the countries invest a small portion of their annual surpluses in gold.

Mr. Nuwayhid advises that the Arabs put 70% of their company and real estate investments in industrial and agricultural projects in Arab and Third World nations that guarantee the investments against nationalization and confiscation. The rest of the investment should be in the West, he said.

Mr. Nuwayhid asserts that "as long as the U.S. dollar remains the major reserve currency, it is bound to have a downward slope in the long run even though it could move up or down within an economic cycle." Because a lower dollar lowers oil import bills, which are paid for in dollars, he charges that the U.S., the Common Market and Japan aren't eager to defend it on foreign-exchange markets. Consequently, he argues, oil exporters should start pricing petroleum in a basket of currencies, though the dollar should continue to be a settlement currency. Some oil-exporting countries fear that using a currency basket would seem to indicate a lack of confidence in the dollar and would result in a substantial loss in the value of their accumulated dollar investments, which constitute about 75% of their total net foreign assets, Mr. Nuwayhid says. But he argues that the dollar's payment function would enhance the dollar.

Yugoslavian Prices Higher

BELGRADE (AP)—Consumer prices in Yugoslavia rose 8.4% in January, a government spokesman said.

Doc. No. 8

SUMMARY OF DOCUMENT FURNISHED BY
U.S. EXECUTIVE BRANCH AGENCY

A European banker discussed OPEC investments and the recent weakness of the dollar with a U.S. official in late 1977. The banker said that there had not been a movement by the Middle East oil producers away from the dollar and he did not foresee one. In his view, other national currencies or gold were simply not economically feasible alternatives for investing their large accumulated surpluses. He did feel, however, that the OPEC countries would seek greater diversification than in the past when investing newly generated revenues. Any significant movement out of the dollar by the OPEC countries, he commented, would inevitably weaken it further and thus have an adverse effect on the value of their remaining dollar assets. He compared the current situation of the OPEC countries with regard to the dollar to that of Middle Eastern countries and sterling several years ago and felt that there were a number of similarities.

While the banker viewed the OPEC countries as being locked into the dollar, at least over a short term, he said they were certainly not indifferent to the current weakness of the dollar. It should not be assumed, he remarked, that the OPEC countries will put up with a falling dollar indefinitely. He said he had talked with persons who had been present at meetings between senior U.S. officials and high officials of a Middle East country and that the U.S. officials had not allayed their fears about the future course of the dollar.

The banker said that the Arabs had an emotional streak and that there was always a chance that a new Middle East conflict or some other dramatic event might convince them to move out of the dollar -- even to their own economic detriment. He opined that the OPEC willingness to continue to invest in long-term US Treasury securities was a key factor. He said that any indication that the surplus countries were moving out or significantly reducing their purchases of these instruments would be a real danger sign.

Asked what he felt the US Government could do to curb the current plummetting of the dollar, the banker replied that uncertainty was at the root of the dollar's difficulties and that even somewhat disagreeable news would be better accepted by the market than the present situation of continued open questions regarding future US Government economic policies and appointments. He expressed the belief that determined steps to reduce uncertainty by the USG could break the current negative psychology of the market and quickly lead to stabilization of the dollar. Of particular importance, he said, would be evidence of closer cooperation between the US and major foreign monetary authorities, including those of Saudi Arabia.

The banker felt the general economic outlook for the United States was very good. Even the trade deficit, he said, has its bright side: Since it is due almost entirely to imports of oil and Japanese goods, he considered it more amenable to correction than if it were due to structural problems. He saw little evidence of a general lack of competitiveness of US exports. Given the differential in inflation rates, however, he did foresee a continued, gradual decline of the dollar vis-a-vis some European currencies although not at anything like the rate of the past few months.

The banker also made a few comments about the investment strategies of the Middle East oil exporters. He said that when the really large surpluses began to emerge after the dramatic price increases of 1973, most of the money was invested in call deposits. Gradually, as these countries have gotten a better idea of their government-operating needs and the cost of their development plans, they are placing more and more money at longer term -- even for as much as 3 to 5 years. He noted that while it was safe for banks of his country to borrow long and lend short, it was not profitable, particularly given the strong competition among banks from different countries. He said that deposits for six months to one year would better match up with the needs of banks of his country of obtaining funds to permit them to roll over Euro-dollar credits for their customers.

The banker said that only relatively small amounts of the OPEC investable surplus have gone into the US stock market. Moreover, of the amount that has been placed in US securities, only a small proportion, in his view, has been channelled through banks of his country. He confirmed that there is current hesitation by Middle Eastern investors to go into US stocks because of the lackluster performance of Wall Street. On the other hand, he said, Wall Street's current problems are not the result of a pull-out of the OPEC funds.

Doc. No. 7

SUMMARIES OF DOCUMENTS FURNISHED BY
U.S. EXECUTIVE BRANCH AGENCY

Summary: In a philosophical discussion in early 1979 between a US official and a foreign official of a Middle Eastern country, the foreign official expounded some of his views on oil prices and production with particular reference to efforts to encourage a realistic view of the oil supply situation on the part of American officials. He criticized the apparent unwillingness of the USG to understand the requirements of the oil producers. He further expatiated on his philosophy regarding appropriate levels of his country's oil production suggesting that oil production levels could be cut back if the foreign investment climate, particularly in the US, became less hospitable. End Summary

During an hour-long discussion between a US official and a foreign official of a Middle Eastern country, the foreign official unburdened himself of a number of complaints about US attitudes with respect to the oil price situation. He was obviously annoyed because of the US criticism of what the US considers an excessive OPEC oil price rise. He maintained that US officials should have been aware of the pressures in the oil market as a result of outside factors, including the decline of the dollar. He suggested that, when the US is advised of an irreversible trend, it should not press the oil producers to buck this trend which they might only do at great sacrifice politically and financially. He complained that US officialdom, both publicly and privately, insisted on refusing to see the reality of the situation. He claimed that certain Middle East countries could not have limited the price increase for 1979 to 10 percent if they had not offered a "sweetener" in the form of the quarterly increases.

The US official responded by noting he had been aware of their intention to raise the oil price by no less than 10 percent. However, such an increase appeared to the US to be excessive, particularly in the light of the overall world economic situation as well as the US internal position. Certainly, from the domestic political point of view, no US official could endorse a 10 percent increase in the price of such an important world commodity because of the serious impact such an increase would have both on the US and, even more so, on the developing countries which have no oil resources. Given the US global role, the US had a responsibility to them, as well as to its own people, to try its very best to convince the OPEC oil producers to exercise restraint in their price fixing decision. The US regretted very much that it was not successful in this effort, since it believed that the overall impact on the world economy would be distinctly unfavorable.

The foreign official insisted that oil producing countries did recognize their responsibility toward the world economy and claimed their price increases were not unreasonable. He maintained that, if they had taken the Iranian situation fully into account, prices could have been much higher. He then read from a telex citing current spot price bids for various grades and qualities of crude oil. He expected the spot market to climb higher. He noted that the bids completely outran the offers, even at these prices.

The foreign official then delved into his country's philosophy on oil production, indicating that there were two schools of thought on this question. The first he considered too inflexible, i.e., demanding the restriction of oil production to what is actually needed for domestic budgetary and development purposes, while the second school preferred a more flexible policy which would enable his country to maintain its present program of outside investments. He said he was now leaning toward the first because foreign investment opportunities, in his opinion, were becoming more difficult. The US official asked whether the US was covered by his statement on investment opportunities because he believed that investment opportunities in America were quite extensive. The foreign official said that he saw an attitude developing in the US and cited the current IRS proposal to tax real estate investments by foreign governments as one example and the public opposition to purchases of farm land by Europeans as another. He believed that the US public was being excited unnecessarily about investment activities which were negligible in comparison to the size of the US economy and that, as a result, this would lead to legislative proposals to restrict investments. He, himself, was very pessimistic about the investment future in the US.

The US official suggested that he was overly pessimistic. He noted that, in the case of tax on real estate investment, this involved a matter in which American citizens were in fact being discriminated against by having to pay tax on this type of commercial activity while foreign governments went tax free. As he, himself, recognized, the tax cost in this matter would be relatively small and the investment would still continue to be profitable. He thought that it was important to remove these discriminations which incite public reaction and that, once this was done, the investment picture in the US should remain relatively stable. He stressed that, because of the free enterprise system under which the US operates, it is unlikely that such restrictive policies as he feared could develop, since these would run against the grain of all American principles and beliefs in this respect.

The US official believed the foreign official was attempting to suggest in this discussion of oil prices, production and investment policy that, unless the US investment climate remained relatively hospitable, there was a danger that those oil producing countries with large surpluses such as his own would be forced to reduce their oil production in the future to the disadvantage of the large western oil consumers. The reference to the change in the real estate tax regulation was made only in passing, but obviously was on his mind. The US official believed the foreign official was correct in pointing out that there is a body of opinion in his country which favors a limited production program, but, as the demands upon the Government for development and benefits continue to increase, it is unlikely that this opinion will gain ascendancy. Rather, there will be a continued effort to maintain the level of production stationary. The foreign official seemed to be more annoyed by the fact that he was not able to evoke American appreciation of what he considered to be the realities of the situation. He seemed to think that it was possible for US officials to agree with his assessment of the situation at least privately, even though they had to take certain public positions.

UNCLASSIFIED SUMMARY
CABLE
FROM: US EMBASSY
TO: DEPARTMENT OF STATE
JUNE 1979

SUBJECT: Mideast OPEC Government's Investment Strategy

1. During call on high official of Mideast OPEC Government, he told me his government's investment strategy would continue to feature major concentration in U.S. dollar assets equivalent to 45-65 percent of surplus funds for CY 1979. His Government would also plan to diversify its increased investment in Western Europe, where they would look into admittedly limited opportunities in smaller countries and also a number of good prospects which may be available in a larger one. In this connection, however, there are taxation problems which still need to be ironed out. In major change in investment policy, government would now return to market in a certain European currency from which it had previously withdrawn.

2. In the U.S., Government would expect to move more broadly into industrial projects and investment. In response to my query, official said that freeze on certain investments was still on because of uncertainty as to application of new IRS regulation under Section 892, but would probably be lifted soon. He expected government go ahead with one major investment which looked very promising. However, with respect to other investment, his government, in view of Section 892 uncertainty, will probably establish offshore companies in the Bahamas, etc., similar to those set up by another Mideast government, through which it would conduct realestate investments.

3. I ascertained that official seemed to be less concerned about the added possibility of public disclosure as a result of a broader investment program. He hoped, however, that there would not be any special publicity accorded to his country's investments, information about which would be provided of course, to US authorities. He maintained that previous concern about investment disclosure related more to technical problems involved in the movement of his country's money in the stock market.

4. Official expressed his appreciation of the trust and confidence he had been able to establish with us in dealing with delicate financial matters. I thanked him for his comment and assured him that Embassy wants to remain worthy of his trust and confidence.

5. Government's investment strategy indicates officials' continued faith in investments in US dollar - it appears that the government of this country will possibly have a greater impact in US investment field as it emerges into a less conservative and more extensive investment program. Naturally, if the IRS gives a more favorable interpretation to its revised regulations, the government of this country is likely to invest more in U.S. real estate because of the greater return it would receive.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

RECORDS SECTION
APR 28 1975

Office Correspondence

To Files

From R. H. Mills Jr.

Date April 24, 1975

Subject: Conversations concerning OPEC Euro-currency deposits

In the last few days I have talked with several New York banks about the maturities of OPEC deposits at foreign branches, and about the rates being paid on those deposits. The situation has changed perceptibly since last November, the last time that I tried to make a somewhat systematic inquiry regarding these topics. Maturities have lengthened, and rates are closer to market rates.

Maturities

at Bank A said there was no question that at their foreign branches the average maturity of OPEC deposits had increased. In particular, 6- and 9-month deposits had become a much larger proportion of the total, while the percentage held in call deposits had fallen. The absolute level of call deposits with them had not changed much since November. OPEC depositors at Bank A branches use call deposits as checking accounts -- most of their oil receipts go initially into call deposits, but then soon leave to be invested in other ways or spent.

At Bank B, confirmed the general tenor of these remarks, but from their experience he did not feel the shift had been quite so pronounced. My November conversation had brought out that at Bank B branches the percentage of OPEC deposits in call form has always been much less than at some others, at that time, Bank B told me it was one-fourth to one-third. Thus, there was less scope for a reduction. At present, would guess the call deposit percentage was "no more than a quarter." There was more change as regards the longer maturities. Deposits in the 6- to 12-month range, which had been a very small fraction of the total last autumn, were now 25 to 30 percent of the total, as best could guess.

The lengthening of maturities observed at these two banks was not evident at two others. At Bank C, said that since November call deposits and term deposits had risen in about equal proportions. He thought that the percentage of OPEC deposits in call form was higher at Bank C -- about 75 percent -- than at most other banks. He felt that in the Euro-market as a whole OPEC deposit maturities had risen.

At Bank D, gave me a rundown on the deposits with their London branch, where they have almost the entirety of their OPEC deposits abroad. For deposits from Saudi Arabia, Iran and Libya -- about three-fourths of the total and the only ones he could readily give me data on -- the percentages of the total on October 31, 1974 and February 28, 1975 for three categories of deposits were, respectively, 65 and 71 percent for call money, 25 and 17 percent for deposits of 7 days to one year, and 10 and 12 percent for deposits over one year. The Iranian and Libyan accounts were described as "operating accounts" which fluctuate a lot. Month-end amounts of all OPEC deposits at Bank D's London branch ranged between $900 million and $1.2 billion in the period from October to February, and showed no tendency to grow.

Rates

Both and said that the rate concessions banks have been obtaining on very large OPEC deposits have come down quite a bit since November. They now range from 0 to 1/2 percent -- compared with an average of 1/2 or 3/4 percent before -- and according to are confined almost entirely to the very short-term deposits. noted that OPEC depositors are placing funds with a wider range of banks, and also said they had become more sophisticated and had begun to deal through brokers, enabling them to get better rates. said he knew of one OPEC country that had started dealing through , which does the greatest volume of any broker in the Euro-currency market.

WASHINGTON POST
THURSDAY, 11-23-78

Arabs Buy Stocks in 4 Airlines

Eastern, TWA United Among U.S. Investments

By Nancy L. Ross
Washington Post Staff Writer

Two Middle Eastern oil countries recently bought substantial interests in four U.S. airlines, according to testimony at a Senate hearing yesterday.

A Civil Aeronautics Board record made public by a Senate subcommittee revealed that Abu Dhabi owns between one and 4 percent of the common stock of Eastern Airlines, Trans World Airlines, United Airlines and Seaboard World Airlines. Kuwait has acquired shares in Seaboard and Airborne Freight Corp.

The purchases were made on behalf of the Arab nations by Morgan Guaranty Trust Co. with whom they have discretionary accounts. Abu Dhabi and Kuwait, however, vote their own shares in the corporations. Morgan also has made sizeable investments in these and other airlines on behalf of pension funds, whose shares it votes. The bank has sole voting authority of more than 5 percent of the stock of both United Airlines and American Airlines.

Together, the shares bought for the Arabs' discretionary accounts and those held in trust for pension and other trust funds amount to 12 percent of the total common stock of the six airlines.

Abu Dhabi has become Eastern's third largest stockholder, after the Rockefeller family.

"This looks like recontrol rather than decontrol of the airlines," quipped Sen. Howard Metzenbaum (D-Ohio), the subcommittee's chairman, at the hearing.

The comments and testimony came on the second of two days of hearings devoted to finding out who controls pension funds, how much power funds exercise over corporations whose stock they hold, whether the investments are too concentrated and whether they are made in the best interest of the beneficiaries.

Metzenbaum asked Morgan's executive vice president, Harrison Smith, what other U.S. industries foreign governments were buying up.

Smith replied that their other investments were very diversified. Abu Dhabi has $900 million invested through Morgan. Kuwait's portfolio amounts to about $700 million, and Saudi Arabia's, $600 million, Smith said.

Aside from his concern about foreign interests in U.S. airlines, Metzenbaum used the example to show that voting rights can easily be passed on to beneficial owners.

Smith had testified that few of Morgan's pension fund clients wanted to vote their own stock. In fact, Morgan votes 98 percent of it. As the country's largest trust department with $14 billion in pension fund assets ($10 billion in equities), Morgan is thus in a position to wield enormous power.

Prof. Roy Schotland of Georgetown University proposed a law be enacted requiring trust departments to pass through voter rights for securities held by pension funds to the beneficiaries, employes and retirees. The purpose is to protect their interests so that, as several union representatives testified, union pension fund members do not find themselves investing in non-unionized companies that may put them out of business. Or so cities like Cleveland do not find that 92 percent of their public pension funds are being invested out of state.

Opponents of this idea argue that investments for defined benefit plans (those that promise beneficiaries a given sum on a given date) should be left up to professional managers because they bear the risks.

Both Morgan and Citibank said they would not accept any accounts with third-party control over how the money is to be invested, except for general policy on the mix of investments or securities versus fixed income. They were adamantly opposed to using social responsibility as an investment criterion, but finally said they might consider such guidelines if the investments met all other financial criteria.

Whereas the Employe Retirement Income Security Act of 1974 specified that investments should be made solely for the benefit of beneficiaries

See PENSION, K3, Col. 2

Two Arab Nations Invest In Major U.S. Airlines

PENSION, From K1

—a view still held by the vast majority of fund managers—there is growing sentiment that criteria other than maximum yield also should be considered.

During the hearing, union officials, city managers and private investment advisers sought to point out that investing in businesses concerned with social good can also be good business financially, that "do-goodism" is not a sure money loser as is widely believed.

Jeffrey Friedman, vice president of the Dreyfus Third Century Fund, said his mutual fund's performance ranks 79 out of 480 this year, even though investments are restricted by social criteria.

The fund will not invest in any company it determines has an unsatisfactory record in equal opportunities for minorities, occupational safety, environmental protection and consumer protection.

It has a list of 300 approved companies in which it is willing to invest. Rather than rule out any particular industry, such as tobacco or copper, it tries to select the most responsible companies in each industry, he said.

During the first nine months of 1978, the Dow Jones Averages (adjusted upward for dividend reinvestment) advanced 8.6 percent; the Dreyfus Third Century Fund was up 27.2 percent. However, little of the $23 million fund as yet comes from pension plans. A study by Corporate Data Exchange showed that as recently as 1976, social concerns were still considered irrelevant to investments, whether the funds controlled by employers, jointly by union or city officials.

Metzenbaum said after the hearings that perhaps pass-through of voter rights and socially responsible investing were ideas whose time had not yet come, but he wanted to air them before introducing legislation. The next hearing will be Feb. 7.

(PLEASE NOTE: This is a summary from Federal Reserve Board internal memos, setting forth information which was presented to the Board of Governors.)

The Investment of OPEC Surpluses, 1974-79

In 1974, in the immediate wake of the enormous jump in oil prices at the start of that year, the OPEC countries' current account surplus soared to approximately $70 billion. The largest type of investment flow emanating from this surplus was the depositing of some $23 billion in the Eurocurrency market, both in London and in other centers.[1/] The identified amounts invested elsewhere were much smaller. We estimate that about $12 billion flowed to the United States in 1974. This was invested largely in Treasury securities (almost $6 billion) and in commercial banks ($4 billion, mostly deposits and certificates of deposit). Smaller amounts flowing to the United States were invested in securities other than Treasury issues, and in miscellaneous assets not in the form of securities or holdings at banks; these latter included real estate and other direct investment, prepayments on U.S. exports, and debt amortization. Other known flows in 1974 included investments in the United Kingdom ($7 billion, largely liquid sterling assets such as Treasury securities and deposits at banks and other institutions) and in international financial institutions ($4 billion, principally IBRD bonds and loans to the IMF Oil Facility).

These identified investments total $46 billion. Comparing this with the $70 billion surplus it can be seen that there was something like $24 billion (over one-third of the estimated total investment flow) that cannot be identified in any systematic way. We do know that little if any could have been placed in the United States or United Kingdom, otherwise those countries'

1/ The figures cited for Eurocurrency deposits in this summary include some relatively small amounts of domestic currency deposits in banks in countries other than the United States and United Kingdom.

reporting systems would have picked it up, and little if any could have gone into the relatively small Eurocurrency centers not covered by existing reporting networks. A few individual transactions widely reported in the press (such as the Iranian and Kuwaiti investments in Krupp and Daimler-Benz) are all that is known about this category of basically unidentified flows. In all of the later years as well there has been a relatively large unidentified component in the total OPEC investment flow.

In the next three years 1975-77 the OPEC surplus was substantially smaller, amounting, according to our estimates, to $31, $37, and $30 billion. The surplus was reduced initially because of the effect of the 1975 recession on oil demand, and throughout the period because of rapidly rising OPEC imports of goods and services. Of the cumulative surplus of $98 billion in those years approximately one-third, or $33 billion, went into Eurocurrency deposits, a proportion only slightly smaller than in 1974. (See attached table for data for individual years.) Almost as much went into investments in the United States -- $31 billion, or 31-1/2 percent of the surplus. In absolute amount the annual average of the investments in the United States in that period was smaller than the 1974 volume, but as a proportion of the overall surplus that average was much higher than the 1974 flow. Investments in Treasury securities and bank liabilities were smaller in each of the years 1975-77 than in 1974, but investments in non-Treasury securities were larger.

In 1975-77 as a whole there was no further investment in the United Kingdom on an overall net basis; a feature was the $2 billion equivalent net liquidation of sterling balances in 1976 when the pound was under pressure. Investments in international institutions held at about $4 billion in 1975 but dropped to $2 billion the next year and by 1977 had become negligible, partly because of the phase-out of the IMF Oil Facility. The unidentified flows in 1975-77 totalled $27 billion -- again, presumably all outside the areas covered by the identified flows.

As OPEC imports continued to climb in 1978, and as oil prices were temporarily held stable, the OPEC surplus contracted sharply; we measure it at $7 billion for 1978. New investments in Eurocurrency deposits tapered off to $3 billion, while the flow to the United States was only $1 billion. Other identified flows were negligible.

The very large increases in oil prices that occurred throughout 1979, and a slowing of OPEC -- especially Iranian -- imports boosted the OPEC surplus for last year to about $65 billion. Although information on investment flows is generally lacking for the fourth quarter, on the basis of rough estimates for the late months of 1979 it appears that something like $38 billion went into Eurocurrency deposits in 1979 of which perhaps $15 billion was placed in the final quarter. The $38 billion figure is about 60 percent of the year's surplus, and this represents a very sharp increase, compared with earlier years, in the share of total OPEC investments channeled into this type of holding. The United States attracted only about $7 billion of OPEC funds in 1979, and the United Kingdom around $2 billion, while there was apparently a slight net reduction in investments in international institutions.

Estimated Disposition of OPEC Surpluses
(Billions of dollars)

	1974	1975	1976	1977	1978	1979e
Estimated Current Account Surplus	70	31	37	30	7	65
Investments:						
In the United States	12	10	12	9	1	7
Treasury securities	6	3	3	3	-2	)
Other securities	1	3	3	3	2	) 7
Com'l bank liabilities	4	1	2	*/	1	)
Other 1/	2	3	4	2	1	*/
In the United Kingdom	7	*/	-1	1	*/	2
Liquid sterling assets	5	0	-2	*/	*/	2
Other	2	*/	1	1	*/	*/
In the Eurocurrency market 2/	23	9	13	12	3	38
In international financial institutions	4	4	2	*/	*/	-1
Subtotal	47	23	26	22	4	46
Unidentified investments (net)	24	8	11	8	3	19

e Estimates. Data on even the identified investments generally are available only through the third quarter.
*/ Less than $1/2 billion.
1/ Includes real estate and other direct investment, prepayments for exports from the United States, debt amortization, etc.
2/ Includes relatively small amounts of domestic currency deposits in banks outside the United States and United Kingdom.

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OPEC: Current Account
($ billion)

	1974	1975	1976	1977	Forecasts 1978	1979
Oil Exports (govt. take)	108.2	98.3	117.3	131.6	126.6	129.5
Non-Oil Exports (fob)	7.3	7.1	8.5	10.4	11.4	12.8
Imports (fob)	-37.0	-57.4	-68.8	-84.8	-95.8	-105.5
Trade Balance	78.5	48.0	57.0	57.2	42.1	36.8
Services and private transfers, net	-6.2	-11.5	-17.3	-21.7	-23.9	-26.6
(of which: net investment income)	(2.0)	(3.6)	(4.2)	(5.0)	(6.0)	(6.1)
Current Account Balance 1/ (ex. official transfers)	72.3	36.5	39.8	35.5	18.3	10.2 2/

1/ You will note that the current account estimates for 1976-1977 have changed from the previous estimates of July 1978 which were: 1976—40.4b; 1977—$36.0b. The revisions are based largely on new information contained in recent IMF country reports.

2/ The 1979 forecasts assume no increase in oil prices over 1978. It is estimated that for every percentage point increase in the oil price in 1979, there would be approximately a one billion dollar increase in the OPEC current account balance.

Sources: CIA, IMF, Staff estimates

Treasury/IDN
August 31, 1978

FEDERAL RESERVE BANK
OF NEW YORK

RESEARCH MEMORANDUM

R

To Mrs. Ehrlich

From M. Sakbani
Balance of Payments Division

Date November 28, 1975

Subject Middle East Oil Producers' Investment in U.S. Corporate Equities

Copies To Messrs: A.R. Holmes, Davis, Fousek, Pardee, Willey, Crowley, Miss Greene, Messrs. Klopstock, Thunberg, Barman, Bossy, Kubarych, Levin, S.V.O. Clarke, Iskroff, Mrs. Kuwayama, Messrs. Serex and Sleeper.

The November 1975 issue of Euromoney has an article entitled "OPEC and Equities" by Jeffrey M. Schaefer of the New York Stock Exchange. In it, Schaefer observes that foreigners have been heavy net purchasers of U.S. corporate equities since the mid nineteen sixties. In particular, Schaefer notes that the "Middle East OPEC investors became in 1974 the largest foreign net purchasers of U.S. corporate equities." Despite the recovery in 1975 of the demand for net purchases of corporate stocks by other foreigners, the Middle East oil producers account for more than a third of the net purchases of U.S. corporate stocks by foreigners. This performance is especially impressive when one considers that it reflects direct purchases by Middle East oil producers, and does not include what are presumed to be significant additional investments channeled through Swiss, U.K., and other intermediaries. Most of the Middle East OPEC investment has been carried out by U.S. banks managing funds for OPEC countries.[1/] Schaefer observes, in addition, that OPEC investments in the U.S. stock markets have been characterized by a lower rate of transaction activity (selling and purchasing) than those of European investors.

Regarding total net purchases of U.S. corporate equities by all foreign

1/ OPEC's Middle East oil producers, namely: Iran, Iraq, Saudi Arabia, Kuwait, U.A.E., and Qatar, account for nearly all the net purchases of U.S. corporate equities by Middle Eastern concerns. Thus, the term "Middle East Oil Producers" will refer to these OPEC members in this paper.

countries, Schaefer points out the impressive figures recorded for the first seven months of 1975: over these seven months net corporate equity purchases totalled $2.4 billion, more than the total recorded in any previous full year except 1973. Schaefer sees little doubt that these purchases will continue to grow throughout the second half of 1975 and that this year's total will exceed even the 1973 high-water mark of $2.8 billion. Spurred in part by the proposed changes in the tax laws which were voted on last October by the U.S. House Ways and Means Committee, Schaefer concludes that foreigners will further continue their portfolio investments in U.S. corporate equities.

This note, written at your request, updates Schaefer's data on foreign and OPEC equity investments, explains some salient features of OPEC equity investments in the U.S. and explores the possible consequences of the proposed tax changes if they are enacted.

II. Equity Acquisitions by Foreign Portfolios in 1975

Through September of this year, total foreign net purchases of U.S. corporate stocks reached $3.13 billion. This figure is substantially higher than any recorded for a comparable period. Moreover, it is even higher than any previous annual figure on record. If the present trend in foreigners' acquisition of U.S. corporate stocks persists, 1975 could register a total net addition to foreign portfolios of over $4 billion of these stocks.

Of the recorded foreign net purchases, Middle East oil producers accounted for about $950 million. By the end of 1975, it is likely that their net purchases will approach the $1.3 billion mark. Such a figure would amount to approximately 3.8 percent of the $34 billion combined projected surplus of the Middle East oil producers in 1975.[2] The recorded purchases of the Middle

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2/ Net purchases of U.S. corporate equities by Middle East oil producers were not identified on the Treasury forms prior to September 1974. Hence, it is not possible to contrast 1975 figures with those of 1974. However, in all of 1974, net acquisition of U.S. corporate equities by all foreign countries was only $540 million, with the biggest share of these acquisitions presumably accounted for by the Middle East oil producers

East oil producers, however, are only a part of their actual acquisitions. Lebanese and European banks have traditionally acted as investment agents for the Middle East's oil surplus holders. Therefore, it is possible to conclude that even this $1.3 billion figure for the year understates the likely net acquisitions of corporate stocks by the Middle East oil producers.

III. Characteristics of the Oil Producers' Investment Preferences and Modes of Operation

Traditionally, big international banks have been the managers and investment advisors of the oil producers. As deposit recipients, banks have had long acquaintance with the government officials and the handful of wealthy individuals who control the surplus funds. As providers of investment advice, banks have established a record of mutual trust and confidentiality with these investors. Furthermore, because their business scope is wider than that of the dealers and brokers, the Middle East investor, especially the official one, could do a wide variety of transactions with and through big international banks. In contrast to the banks, the U.S. brokers and dealers are newcomers to the Middle East investment game, and of their very nature have a less varied business scope than the big international banks. Despite considerable inroads made by the U.S. brokers and dealers recently, the dominance of the banks is likely to continue in the near future.

Turning to the investment characteristics of the typical Middle East oil surplus country, Schaefer's observations could be extended and given a plausible logical explanation. The time horizon of typical Middle East portfolio investors (mostly officials) stretches beyond the short run. Consequently, their positioning in the financial markets is predicated on long-term considerations and naturally tends to favor quality stocks of sound fundamentals; hence the low level of transaction activity when compared to other foreign investors.

The Middle East surplus investors (mostly officials) are essentially conservative risk averters. Moreover, their expenditure constraints are more or less predictable over time. Hence, they tend to prefer quality growth stocks of low price variance and a secularly increasing resale value. Because of the predictability of the expenditures and the substantial amount of liquid investments contained in these investors' portfolios, this kind of stocks is more attractive to them than high income yielding stocks which usually do not carry a substantial growth potential. The Middle East surplus holders, except for [Iran and Iraq,] tend to prefer stocks covering a broad area of economic activity. In other words, they can be classified as investors with no specific extra purposes, such as acquisition of ownership in particular industries or promotion of certain sectors that fit into their developmental needs.

IV. Changes In The Tax Regulations and Their Implications

The House Ways and Means Committee's proposed tax changes are incorporated into the Tax Reform Act of 1975. The proposed changes would extend the exemptions from the 30 percent withholding tax[3/] on income from U.S. sources accruing to all foreigners, not just foreign governments and central banks which are already tax exempt under sections 892 and 895 of the U.S. tax code. Since the U.S. has no tax treaties with the Middle East oil producers, such a change would be of great importance to investors in these countries not qualifying under the existing regulations. The withholding tax has been one of the major factors for the reluctance of OPEC countries to commit larger funds than they have done to the U.S. capital markets. Furthermore, when compared to the various segments of the Eurocredit markets, the U.S. markets have no particular edge in other regulatory matters. Thus, the fundamental economic advantages of the U.S. capital markets have been undercut

3/ In a sense, the prefix "withholding" is confusing. This tax is actually a substantive tax of 30 percent on investment returns.

by government regulations. If the proposed bill is passed into law it would probably shift the relative structure of foreign official portfolios towards private long term assets (bank deposits and U.S. obligations held by foreign officials are exempt from the tax), and encourage private foreign placements in the U.S. corporate sector. As things are now shaping up, however, the future of this bill in the House is uncertain and political observers doubt that the odds are in its favor.

In addition to the above-mentioned tax amendments, the IRS has also changed its interpretation of existing tax rules in ways that are of particular interest to the Middle East oil producers. Up to last June the withholding tax has been in effect on foreigners' portfolios except those owned by foreign governments and foreign central banks. The IRS, however, extended last June this exemption to agencies owned by foreign governments and central banks provided that their earnings are derived from "passive investments," e.g., fixed interest deposits, currencies, corporate stocks and bonds, notes and other instruments evidencing loans. This new ruling, in effect, extends the tax exemption to include a broader spectrum of investments by government-owned agencies,[4] and extends the list of exempt instruments from U.S. obligations and fixed income deposits to corporate stocks, bonds, and other debt securities. Since many oil producers, espeically those in the Middle East, have set up a variety of specialized government agencies to handle their surplus funds, such a liberal interpretation of the tax rules by the IRS should be of benefit to them.

Liberalization of the tax rules governing foreign investment in the

4/ There are other criteria for these government agencies to meet in order to qualify for the new exemption. These require that these agencies be wholly owned by foreign governments and not engaged in commercial activities in the U.S., that their income accrue ultimately to official beneficiaries and that their investments be considered "passive." An investment that entails management control or competes with an established U.S. concern is not considered, for the purpose of the IRS, passive. Under the new rules any violation of this "passivity" criterion would subject the entire portfolio of such an agency to U.S. taxes.

U.S. would certainly spur foreigners' interest in the U.S. capital markets. Looking ahead into the future, the U.S. capital requirements are expected to press hard on our domestic financial sources in view of the needed extra resources in the fields of energy, environment and urban development. Foreign investment would be most helpful in fulfilling these needs. By promoting U.S. capital growth, OPEC's drain on the real resources of the U.S. is lessened. As the U.S. recovery exhibits more signs of strength, OPEC should find the capital markets of the U.S. increasingly attractive. In a very few years, OPEC surpluses will be concentrated in the hands of a few Middle East oil producers. These few countries are expected to continue accumulating surpluses even in the 1980's. Consequently, their present characterization as "investors" will be valid for a considerable future length. Undoubtedly, the stock exchanges will be strengthened by this foreign source of new and relatively nonvolatile funds.

B. SAUDI ARABIAN SURPLUSES, INVESTMENTS, AND FINANCIAL STRATEGIES

Wall Street Journal, March 13, 1981, p.1.

Royal Resources

Saudi Central Bank Is Secretive, Conservative And Enormously Rich

Its Bulging Portfolio Includes Debt Issues From AT&T, IBM and General Motors

Restrictions From the Koran

By DAVID IGNATIUS
Staff Reporter of THE WALL STREET JOURNAL

RIYADH, Saudi Arabia – Abdul Aziz Alquraishi disdains the usual Saudi ritual of welcoming visitors with tea and small talk. He doesn't have the time.

As governor of the Saudi Arabian Monetary Agency, which is the Saudi central bank, Mr. Alquraishi (pronounced Al-ko-RAY-shee) directs the investment of $2 billion per week in oil revenue. He manages a portfolio of foreign assets that is estimated by Western bankers at more than $90 billion. Actually, nobody outside the Saudi inner circle knows exactly how large the total is. But it is generally agreed that Mr. Alquraishi controls a larger fund of assets than any other banker – public or private – in the world.

A computer terminal next to Mr. Alquraishi's large black desk helps him monitor the world's financial markets. He touches a few keys, and the morning's foreign-exchange quotations from London appear on the screen. "As you can see," he tells a recent visitor, "today is rather a hard day for the deutschemark."

But the fortunes of foreign currencies are mainly an academic question for Mr. Alquraishi. The Saudi Arabian Monetary Agency (known as SAMA) is simply too big to participate in the private foreign-exchange market. If SAMA tried to convert each day's haul of dollars into other currencies, it would flood the market and depress the value of its own holdings.

Abdul Aziz Alquraishi

Like a well-trained elephant, SAMA has learned to move very cautiously in the delicate world of international ~~finance. Indeed,~~ Mr. Alquraishi and his Saudi deputies are probably among the most conservative bankers in the world. They hate taking financial risks; they try hard to steer clear of politics; and they shun publicity. (Mr. Alquraishi's aides say he is beginning to realize that publicity is inevitable; however, he agreed to be interviewed by this newspaper only after repeated requests and insisted on submitting written answers to written questions, with just a brief face-to-face chat.)

"Professional Considerations"

Above all, SAMA recognizes that the security of the Saudi reserves depends on the stability of the international financial system. Mr. Alquraishi stresses that the Saudi central bank "behaves as responsibly" as any other player in the world banking system and is managed "by identical considerations of prudence." He dismisses the possibility that Saudi oil revenues could be used as a political weapon against the West. "In the management of reserves," he says, "SAMA is governed by professional considerations alone."

Western bankers generally agree that SAMA's careful policies have allowed the petrodollar-recycling process to work fairly smoothly—without the dire consequences that were once predicted. "They've done miracles," says Alan Moore, executive director of Lloyd's Bank International. "The Saudis have learned in five years the skills it took Western banks 100 years to develop."

SAMA's basic investment policy is simple: Don't take any chances on security or liquidity. It can afford to be very choosy. The Saudi agency places bank deposits only with the 75 or so largest international banks that are on its "approved" list.

Furthermore, it purchases corporate debt only from the biggest blue-chip companies, whose bond ratings are AA or above. And when it needs to acquire large amounts of foreign currencies, it deals directly with central banks.

A Kind of Endowment

"The feeling at SAMA is of an endowment holding assets in trust for future generations," ~~says Andreas Prindl, executive~~ director of the Saudi International Bank, a London concern that is 50%-owned by SAMA.

SAMA's investment portfolio is heavily weighted toward the dollar. This is partly due to Saudi confidence in the U.S. economy and U.S. military strength. But it is also due to the simple fact that the Saudis are paid for their oil only in dollars. In recent years, SAMA has tried to diversify its portfolio somewhat by purchasing debt in marks and yen directly from the West German and Japanese governments; nevertheless, by most estimates, about 75% of the agency's foreign assets remain in dollars.

Mr. Alquraishi indicates that SAMA plans to stick with the U.S. currency. "The greater part of our foreign exchange reserves are still and will continue to be in dollars," he says.

SAMA's favorite dollar investment seems to be U.S. government debt. The Treasury market suits the Saudis because it can handle large volumes of dollars quickly and quietly. True, some cynical observers see a vicious cycle at work—in which Saudi oil prices help fuel U.S. inflation and Saudi investments help finance it. But the Saudis counter that they're doing the U.S. and the West a favor by selling oil cheaper than other OPEC countries and by producing at

Please Turn to Page 21, Column 1

Wall Street Journal - March 13, 1981 pp. A1, A21

Royal Resources: The Central Bank Of Saudi Arabia Guards Vast Riches

Continued From First Page

the current high level, which inevitably leads to large foreign assets.

Official U.S. statistics on the size of SAMA's Treasury holdings aren't available (which is one reason the publicity-shy Saudis like doing business with the Treasury). But SAMA's purchases probably account for most of the $24.7 billion in Treasury bills and bonds and other federal-agency issues held as of last September by a group of eight Middle East oil-producing countries.

SAMA's secrecy about the details of its activities affects many of its dealings. For example, its officials are said to have threatened to blacklist any merchant bank that leaks information about a placement with the agency. Moreover, the Saudi bank refuses to invest directly in corporate stocks partly because of fears that the purchases would be disclosed and trigger bad publicity about Saudi takeovers of foreign industry.

But despite SAMA's secrecy, enough information leaks out of the banking community to provide a fairly clear picture of its corporate lending. The procedure is simple enough: A merchant banker, with "ironclad" power to act on behalf of a borrowing company, flies to Riyadh; if his proposal survives an initial screening by SAMA's Western advisers, it goes to a senior investment committee, headed by Mr. Alquraishi. Several weeks later, usually after the banker has returned home, SAMA gives its answer.

A Bit of Advice

There is some disagreement in the banking community about how powerful the Western advisers are. The current crew of seven is on loan from Merrill Lynch & Co., the U.S. investment-banking and financial-services firm, and from Baring Brothers, a British merchant bank. They are paid by SAMA, and their tours of duty in Riyadh are usually for a minimum of two years.

A few bankers maintain that the advisers hold the real power in SAMA; but most believe that the Westerners are kept on a tight leash by their Saudi bosses. (Mr. Alquraishi, although educated at the American University in Cairo and at the University of Southern California, has had no banking experience in the West; prior to his appointment as SAMA governor in 1974, he had been head of the Saudi civil service.) SAMA itself is under the control of the Saudi finance minister, who reports to the senior princes of the governing royal family.

Bankers who have made the trip to Riyadh offer the following guidance: The Saudis like the detailed disclosure of the U.S. Securities and Exchange Commission; and, as a result, they like purchasing debt from publicly traded U.S. companies. They dislike dealing with people who come ill-prepared to meetings. For example, one banker remembers a colleague who emerged "shaken" from a meeting with a SAMA official during which he was asked to summarize "the position of the Bundesbank on deutschemark interest rates and their effect on the dollar."

In recent years, legions of small, poorly capitalized banks and businesses, many of them Arab, have pressed SAMA for deposits or loans. But the agency has learned to refuse applicants not meeting its blue-chip standards; indeed, the Saudis through experience have become much tougher in their negotiations with even the biggest, most powerful borrowers.

"The Saudis make it very clear they aren't giving money away," says Michael Callen, managing director of the Saudi American Bank, a Riyadh-based concern that is affiliated with New York's Citibank. In closing a deal, Mr. Callen says, "SAMA will bargain for the last eighth" of a point.

Growing Portfolio

SAMA's corporate portfolio is growing every month, and it now includes debt issues from dozens of major U.S. and European companies. The major oil companies were added to the list last year, when SAMA decided to reverse its previous ban on investing in a sector on which the kingdom was already so dependent. By the end of the year, SAMA had acquired over $500 million in oil-company debt.

A partial list of SAMA's corporate holdings was compiled recently by Chase World Information Corp., a unit of Chase Manhattan Bank. According to the Chase study, SAMA's purchases of corporate debt include $650 million from American Telephone & Telegraph Co. and its affiliates; $300 million from International Business Machines Corp.; $200 million from U.S. Steel Corp.; $250 million from General Motors Acceptance Corp.; and $75 million from Dallas Power & Light Co., a subsidiary of Texas Utilities Co.

But even with those giant corporations, SAMA's ever-cautious managers don't like to tie up their money for very long. Bankers report that seven years is the longest maturity that SAMA is normally willing to consider.

Strict Rules

SAMA's managers also insist on a fixed rate of interest; they reject the floating-rate approach increasingly favored by bank lenders. And in bargaining over interest rates, the agency doesn't seem to pay much attention to the strictures of the Koran; the sacred book of the Moslems regards interest payments as sinful. But SAMA does maintain one religious taboo in its foreign investments: It tries to avoid buying debt from companies that make "anti-Islamic" products, such as liquor or racy movies.

Islamic banking rules are, however, strictly imposed by SAMA on the Saudi domestic banking system. And this limits SAMA's ability to develop a coherent domestic monetary policy. "They can't use the rate of interest as a lever, because interest doesn't exist," says one Western observer. (Saudi banks make money by charging commissions or service fees on loans; a Western banker notes that with the commission rate at 9% recently, compared with about 17% in nearby Bahrain, there is often a run on loans with a consequent depletion of available funds.)

When they talk about the future, some younger SAMA officials claim they wouldn't be unhappy if the petrodollar surplus disappeared and SAMA retired from international high finance. They argue that that could happen quickly—if the Saudis matched their oil production with the spending needs of the kingdom's development program.

Saudi development spending already is absorbing a much larger share of the kingdom's oil revenues than Western analysts had predicted. During 1978, for example, the pace of domestic spending was so frantic that Saudi Arabia actually recorded a balance-of-payments deficit, forcing SAMA to draw down its reserves.

But last year, as Saudi oil production and prices increased, the surplus ballooned again to a total estimated by a SAMA official at $40 billion. And Morgan Guaranty Trust Co. predicts that the Saudis will add another $44 billion to the surplus this year.

The disenchantment of some SAMA officials at the prospect of acquiring even more paper assets from the West was reflected in a speech last year by SAMA's deputy governor, Ahmet Abdullatif. He noted that a barrel of oil produced in 1974 and invested in Treasury bills now is worth $18; but if the oil had been left in the ground, he observed, it would now be worth $32.

The Wall Street Journal, September 18, 1981

Saudis May Turn More To Investing in Stocks

A WALL STREET JOURNAL *News Roundup*

Saudi Arabia may be in the process of changing its investment strategy, putting greater emphasis on equity investments in energy and technology companies.

Sheik Ahmed Zaki Yamani, the kingdom's oil minister, said in an interview with a London-based Arab magazine, Al-Majallah, "My opinion is that it is necessary to enter into markets other than money markets in what is known as equity capital."

U.S. observers say this isn't the first indication of a possible switch in Saudi investment strategy. A few months ago, the kingdom gave $1 billion to each of two British investment banking firms with instructions to invest the money on the Tokyo Stock Exchange.

While any increased emphasis by Saudi Arabia on U.S. equity markets could be very significant, financial experts familiar with the kingdom doubt that Sheik Yamani was signaling a massive infusion of money into the U.S. stock market.

"The Saudis are very careful not to buy more than 5% of any one (U.S.) company, which would require them to disclose their investment publicly," said one Arab money expert.

U.S. experts also said that, even if there were a major push to buy stocks, Saudi purchases of U.S. Treasury notes and other short-term government instruments wouldn't necessarily decline. That's because Saudi Arabia has so large a surplus fund, about $100 billion.

Sources estimate that Saudi Arabia has bought about 5% of every U.S. Treasury offering over the past four years, making it possibly the biggest investor in the U.S. government.

Personal Income

The Commerce Department reported that personal income rose $26.9 billion last month to a seasonally adjusted $2.446 trillion annual rate, after rising $34.7 billion in July to a $2.419 trillion pace. Personal-consumption expenditures last month increased $26.7 billion to an adjusted $1.889 trillion annual rate, after rising $20.2 billion in July to an adjusted $1.862 trillion pace.

The inflation measure for personal-consumption expenditures, which is reported after a one-month lag, rose 1% in July, after rising 0.5% in June.

Private wages and salaries last month increased 1.1% to an adjusted $1.501 trillion annual rate after rising 0.7% in July to a $1.485 trillion rate. Factory payrolls last month increased 0.9% to an adjusted $395.5 billion annual rate after rising 0.8% in July to a $391.8 billion rate.

Farm owners' income increased 2.5% in August to an adjusted $24.5 billion annual rate, after increasing 3% in July.

Personal interest income rose 2.1% last month to a $315.7 billion annual rate, after increasing 1.6% in July. Dividend income in August rose 1% to a $63 billion pace, after rising 2.1% in July.

Transfer payments, which include Social Security, welfare, unemployment and veterans' benefits, rose 0.4% in August to $343.7 billion after increasing 4.8% in July.

The personal savings rate, which is reported after a one-month lag, fell to 5.4% of disposable income in July from 5.5% in June.

Capacity Utilization

The Fed said August's decline pushed the factory operating rate down to its lowest level since October 1980. The rate for the motor vehicle and parts industry dropped sharply. The rate declined more moderately for the food, textiles, rubber, metals and equipment industries. But the operating rate for the petroleum industry increased for the first month since January, the Fed said.

The operating rate in August for primary-processing industries was an adjusted

BOARD OF GO. RNORS
OF THE
FEDERAL RESER E SYSTEM

Saudi Arabia cc Chm B.

..ice Correspondence

Date February , 1975

Mr. S. Pizer

Subject: Visit to the Board by Middle East Government Official

From Alex Lang

[Deletions by Federal Reserve]

[According to a recent U.S. Embassy report from Saudi Arabia, the Saudi Government's current emphasis is on investments in top grade, government-guaranteed debt instruments of about 10 year maturity, with individual deals of no less than $50 million, and preferably in the range of $100-$500 million.]

SAUDI ARABIAN CURRENT ACCOUNT BALANCES

($ Billions)

	1976 1)	1977 1)	1978 1)	1979e	1980e 2)	1980e 3)
Exports	34.6	39.8	36.7	43.3	47.2	51.9
Oil (Gov't Take) 4)	34.5	39.7	36.6	43.2	47.1	51.8
Non-oil (fob)	.1	.1	.1	.1	.1	.1
Imports (fob) 5)	10.4	14.3	19.5	23.8	29.0	29.0
Trade Balance	24.2	25.5	17.2	19.5	18.2	22.9
Services & Private Transfers, net	-6.0	-7.5	-12.4	-15.1	-18.3	-18.3
Freight & Insurance	-2.1	-2.5	-3.3	-4.1	-5.2	-5.2
Investment Income	+2.9	+4.0	+4.3	+4.3	+4.3	+4.3
Travel & Transportation 7)	+1.1	+1.4	+1.7	+2.1	+2.6	+2.6
Private & Gov't Services 8)	-6.9	-8.9	-12.6	-14.5	-16.7	-16.7
Private Transfers 8)	-1.0	-1.5	-2.5	-2.9	-3.3	-3.3
Current Account Balance (excludes official transfers)	+18.2	+18.0	+4.8	+4.4	-0.1	+4.6

Office of Saudi Arabian Affairs

April 27, 1979

FOOTNOTES

1. 1976, 1977, and 1978 figures are consistent with the April 12, 1979 "Saudi Arabia - Recent Economic Developments" published by the IMF. 1978 figures are provisional.

2. Assumes no increase in oil prices.

3. Assumes a 10% increase in oil prices.

4. Saudi crude oil production including natural gas liquids is estimated at 9 million b/d in 1979 and 9.6 million b/d in 1980. Crude oil exports including ngl are estimated at 8.6 million b/d in 1979 and 9.1 million in 1980.

5. Imports are projected to increase by 22% in 1979 and 1980.

6. Freight and insurance is 17% of imports for 1979 and 1980.

7. Estimated to increase by 25% in 1979 and 1980.

8. Estimated to increase by 15% in 1979 and 1980.

April 27, 1979

SAUDI ARABIA
CURRENT ACCOUNT BALANCE
($ BILLIONS)

	1976	1977	1978	1979e
Exports	34.0	38.8	36.4	48.3
Oil (Gov't Take)1/	33.9	38.7	36.3	48.2
Non-oil (fob)	.1	.1	.1	.1
Imports (fob)2/	10.8	15.1	18.6	22.8
Trade Balance	+23.2	+23.7	+17.8	+25.5
Services & Private				
Transfers, net	-5.7	-6.6	-9.2	-11.5
Freight & Insurance3/	-1.9	-1.9	-2.3	-2.8
Investment Income4/	+2.9	+4.0	+4.0	+4.3
Travel & Transportation5/	+1.0	+1.3	+1.6	+2.0
Private Services6/	-2.5	-3.4	-4.3	-5.2
Government Services6/	-4.2	-5.3	-6.6	-7.9
Private Transfers6/	-1.0	-1.3	-1.6	-1.9
Current Account Balance (excludes official transfers)	+17.5	+17.1	+8.6	+14.0

e = Estimate

Office of Saudi Arabian Affairs — February 26, 1979

FOOTNOTES

1. Saudi crude oil production including natural gas liquids is estimated at 10.3 million b/d in 1979. Crude oil exports including ngl are estimated at 9.8 million b/d in 1979.

2. Imports are projected to increase by 23% in 1979.

3. Freight and insurance is estimated at 12.5% of imports in 1979.

4. A 7.0% annual rate of return is assumed on SAMA foreign investments in 1978 and 7.5% in 1979.

5. Estimated to increase 25% in 1979.

6. Projected to increase 20% in 1979.

February 26, 1979

SAUDI ARABIA
CURRENT ACCOUNT BALANCE
($ BILLIONS)

	1976 1/	1977 1/	1978	1979e
Exports	34.0	38.8	36.4	44.3
Oil (Gov't Take) 2/	33.9	38.7	36.3	44.2
Non-oil (fob)	.1	.1	.1	.1
Imports (fob) 3/	10.8	15.1	18.6	22.8
Trade Balance	+23.2	+23.7	+17.8	+21.5
Services & Private				
Transfers, net	-5.7	-6.6	-9.2	-11.5
Freight & Insurance 4/	-1.9	-1.9	-2.3	-2.8
Investment Income 5/	+2.9	+4.0	+4.0	+4.3
Travel & Transportation 6/	+1.0	+1.3	+1.6	+2.0
Private Services 7/	-2.5	-3.4	-4.3	-5.2
Government Services 7/	-4.2	-5.3	-6.6	-7.9
Private Transfers 7/	-1.0	-1.3	-1.6	-1.9
Current Account Balance (excludes official transfers)	+17.5	+17.1	+8.6	+10.0

e = Estimate

Office of Saudi Arabian Affairs February 14, 1979

FOOTNOTES

1. Saudi crude oil production including natural gas liquids is estimated at 8.9 million b/d in 1979. Crude oil exports including ngl are estimated at 8.7 million b/d in 1979. Due to the Iranian shortfall Saudi quarterly production figures are estimated as follows:

1st	10.5 million b/d
2nd	9.5 million b/d
3rd	8.8 million b/d
4th	8.0 million b/d

In addition, the quarterly price differential for Saudi marker (light) crude and heavy crude, subsequent to the 1978 OPEC decision, is as follows:

	Marker (light)*	Heavy
1st	$13.335 p/b	$12.511 p/b
2nd	$13.843 p/b	$12.988 p/b
3rd	$14.161 p/b	$13.286 p/b
4th	$14.452 p/b	$13.643 p/b

The production ration between light and heavy is estimated at 68% and 32% respectively.

2. Imports are projected to increase by 23% in 1979.

3. Freight and insurance is estimated at 12.5% of imports in 1979.

4. A 7.0% annual rate of return is assumed on SAMA foreign investments in 1978 and 7.5% in 1979.

5. Estimated to increase 25% in 1979.

6. Projected to increase 20% in 1979.

7. 1974-1976 figures are consistent with the IMF Balance of Payments Yearbook, 1977. 1977 and 1978 figures are provided by CIA. 1979 figure is provisional.

* $.23 is deducted from each barrel price to determine net government take.

February 14, 1979

SAUDI ARABIA
CURRENT ACCOUNT BALANCE
($ BILLIONS)

	1976 1/	1977 1/	1978	1979e
Exports	34.0	38.8	36.4	36.1
Oil (Gov't Take) 2/	33.9	38.7	36.3	36.0
Non-oil (fob)	.1	.1	.1	.1
Imports (fob) 3/	10.8	15.1	18.6	22.3
Trade Balance	+23.2	+23.7	+17.8	+13.8
Services & Private Transfers, net	-5.7	-6.6	-9.2	-11.6
Freight & Insurance 4/	-1.9	-1.9	-2.3	-2.8
Investment Income 5/	+2.9	+4.0	+4.0	+4.2
Travel & Transportation 6/	+1.0	+1.3	+1.6	+2.0
Private Services 7/	-2.5	-3.4	-4.3	-5.2
Government Services 7/	-4.2	-5.5	-6.6	-7.9
Private Transfers 7/	-1.0	-1.5	-1.6	-1.9
Current Account Balance (excludes official transfers)	+17.5	+17.1	+8.6	+2.2

e = Estimate

Office of Saudi Arabian Affairs December 5, 1978

FOOTNOTES

1/ 1976 and 1977 figures are consistent with the August 1978 IMF Economic and Financial Survey of Saudi Arabia. 1977 figures are provisional.

2/ Saudi crude oil production including natural gas liquids is estimated at 8.5 million b/d in 1978 and 1979. Crude oil exports including ngl are estimated at 8.1 million b/d in 1978 and 8.0 million b/d in 1979.

3/ Imports are projected to increase by 23% in 1978 and 20% in 1979.

4/ Freight and insurance is 17.5% of imports in 1976 and 12.5% in 1977 and estimated at 12.5% in 1978 and 1979.

5/ A 6.5% annual rate of return is assumed on SAMA foreign assets in 1978 and 7% in 1979.

6/ Estimated to increase 25% in 1978 and 1979.

7/ Projected to increase 25% in 1978 and 20% in 1979.

Office of Saudi Arabian Affairs December 5, 1978

ACTION | BRIEFING | [XX] INFORMATION

Inter-Office Memorandum

Date: JUN 24 1977

For: Lewis W. Bowden

From: Bonnie Pounds BP

Subject: Saudi Arabia's Current Account Balances

Attached are estimates of Saudi Arabia's current account balances through 1981 which we provided to the Office of Developing Nations Finance on 6/22/77. The figures will be used in Treasury's new estimates of OPEC's current account surpluses. We will pass on the completed product when it is available.

Attachment
Current Account Balances

WHAT RATES OF INCREASE FOR IMPORTS ($\Delta \uparrow M$) did you use? Doesn't seem to agree with CIA projections. LB

SAUDI CURRENT ACCOUNT

COUNTRY Saudi Arabia

OFFICER Gay Hoar

DATE 6/21/77

CURRENT ACCOUNT BALANCES
($ Millions)

	1976	1977	1978	1979	1980	1981
Exports						
Oil (Gov't Take)	33,400	41,300	37,600	37,800	42,400	51,900
Non Oil (fob)	100	100	100	100	200	200
Imports (fob) Nominal + Real $ 10.6	-12,800	17% -15,000	16% -17,400	15% -20,000	-22,800	-26,000
Trade Balance	20,700	26,400	20,300	17,900	19,800	26,100
Services & Private						
Transfers, net	-4,440	-4,730	-4,150	-4,050	-3,870	-3,870
Freight & Insurance 1]	-2,100	-2,400	-2,600	-2,800	-2,950	-3,380
Investment Income 2]	+3,260	+3,870	+5,200	+6,100	+6,980	+7,910
Local Cost of Oil Production	+400	+400	+450	+450	+500	+600
Other 3]	-6,000	-6,600	-7,200	-7,800	-8,400	-9,000
Current Account Balance (excludes official transfers)	16,260	21,670	16,150	13,850	15,930	22,230

1] 16.5% of imports in 1976; 13% of imports in 1981.
2] Foreign assets 6/76 $50 bil. assumed return on assets 6.5%. Annual investible surplus is current account balance less grants.
3] Includes other service payments and foreign remittances.

OUTGOING TELEGRAM

2, D ③

CONFIDENTIAL

TREAS: JGHOAR:MH
4/19/78 566-8423

TREASURY:DMASLIN
TREASURY:LWBOWDEN

TREASURY:BPOUNDS

TZTG (Hoar)

PRIORITY AMEMBASSY JIDDA, ROUTINE AMCONSUL DHAHRAN,
ROUTINE USLO, RIYADH

E.O. 11652: GDS

TAGS: EFIN, SA

SUBJECT: SAUDI FOREIGN ASSETS AND CURRENT ACCOUNT SURPLUS

REF: JIDDA 2066

1. TREASURY HAS REVISED ITS 1977 SAUDI CURRENT ACCOUNT SURPLUS TO DOLLARS 18 BILLION

TREASURY CURRENT ACCOUNT BALANCE EXCLUDES OFFICIAL TRANSFERS WHICH ARE GOVERNMENT GRANTS. AID FLOWS (BI-LATERAL AND MULTILATERAL, CONCESSIONAL AND NON-CONCESSIONAL LOANS) ARE IN THE CAPITAL ACCOUNT.

WE EXPECT THE FIGURE WAS SOMEWHAT HIGHER IN 1977.

IN ADDITION, CURRENT ACCOUNT ESTIMATES ARE ON ACCRUAL BASIS WHILE INVESTMENTS ARE ON CASH FLOW BASIS. THIS COULD ACCOUNT FOR THE REMAINING DOLLARS 2 BILLION DISCREPANCY.

2. TREASURY ESTIMATES 1977 SAUDI OIL REVENUES (GOVERNMENT-TAKE) AT DOLLARS 38.7 BILLION AND SAUDI IMPORTS AT DOLLARS

CONFIDENTIAL
CLASSIFICATION

OUTGOING TELEGRAM
Continuation Sheet

CONFIDENTIAL 2

14.3 BILLION RESULTING IN A TRADE BALANCE OF DOLLARS 24.5 BILLION. SERVICES AND PRIVATE TRANSFERS TOTAL DOLLARS 6.3 BILLION GIVING AN OVERALL SURPLUS OF DOLLARS 18.2 BILLION (EXCLUDING OFFICIAL TRANSFERS). SAMA'S ESTIMATE OF A DOLLARS 13 BILLION CURRENT ACCOUNT SURPLUS IN 1977 INCLUDES OFFICIAL TRANSFERS.

3. TREASURY IS ESTIMATING 1978 SAUDI CURRENT ACCOUNT SURPLUS AT DOLLARS 10 BILLION, A DOLLARS 8 BILLION DROP FROM 1977. THE DOLLARS 10 BILLION EXCLUDES GOVERNMENT GRANTS AND ALL AID FLOWS REFERRED TO IN PARA 1. 1978 OIL REVENUES ARE ESTIMATED AT DOLLARS 35.6 BILLION (GOVERNMENT-TAKE), A DOLLARS 3 BILLION DECLINE FROM 1977. THIS ASSUMES OIL PRODUCTION OF 8.5 MILLION B/D AND EXPORTS OF 8.1 MILLION B/D. AT THE SAME TIME, WE ASSUME IMPORTS, WHICH INCREASED OVER 30 PERCENT IN 1977, WILL SLOW SLIGHTLY AND INCREASE ABOUT 25 PERCENT, OR DOLLARS 3.5 BILLION, TO ALMOST DOLLARS 18 BILLION IN 1978. REMAINING DOLLARS 1 BILLION DECLINE IN CURRENT ACCOUNT SURPLUS IS ACCOUNTED FOR BY INCREASE IN NET SERVICES AND PRIVATE TRANSFERS.

4. FYI. IMF IS REPORTING A 1976 SAUDI CURRENT ACCOUNT SURPLUS OF DOLLARS 17.5 BILLION (EXCLUDING OFFICIAL TRANSFERS PER TREASURY'S METHOD OF CALCULATING CURRENT ACCOUNT BALANCE). THIS FIGURE IS BASED ON REPORTS SENT TO IMF BY SAMA WHICH PUBLISHES ITS OFFICIAL BALANCE OF PAYMENTS STATISTICS IN A DIFFERENT FORM IN ITS ANNUAL REPORT. WHEN SAMA REPORTS ITS CURRENT ACCOUNT SURPLUS IT INCLUDES OFFICIAL TRANSFERS (GRANTS) WHICH TOTALLED DOLLARS 3.5 BILLION FOR 1976. THUS 1976 CURRENT ACCOUNT SURPLUS AS REPORTED BY SAMA IS DOLLARS 14 BILLION (DOLLARS 17.5 MINUS DOLLARS 3.5).

5. DETAILED SAUDI CURRENT ACCOUNT FIGURES AS ESTIMATED BY TREASURY FOR 1976, 1977 AND 1978 WITH FOOTNOTES AND EXPLANATIONS AND NEW IMF BALANCE OF PAYMENTS YEARBOOK DATA HAVE BEEN POUCHED.VV

SAUDI ARABIAN CURRENT ACCOUNT BALANCE

The attached table presents the Saudi current account balance for 1976 as reported in the IMF Balance of Payments Yearbook and Treasury's estimates of the current account balance for 1977 and 1978. The IMF figures are based on reports sent to the IMF by SAMA which publishes its official balance of payments statistics in a different form in its Annual Report.

The IMF has reported a 1976 Saudi current account surplus of $17.5 billion. The IMF figures for 1976 contain a couple of surprises. Freight and insurance is reported at $3 billion, 27% of imports, a much higher figure than we expected even though this was the height of port congestion and extremely high demurrage charges. The IMF reports a $3.0 billion investment income credit which is primarily income on SAMA foreign assets. Treasury had been estimating a similar return on Saudi foreign investments. We had not been aware of the magnitude of private sector (business and bank) interest payments on borrowings abroad. For 1976 the IMF reports an investment income debit of $1.1 billion. Thus net investment income for 1976 is only +$1.9 billion. The IMF reports $4.0 billion of other service payments and $1.0 billion of private remittances.

Treasury is estimating a Saudi current account surplus of $18 billion for 1977. Saudi oil revenues which increased to almost $39 billion in 1977 were offset by merchandise imports which increased over 30% to around $14 billion. CIA has estimated Saudi oil production at 9.4 million barrels per day (b/d) in 1977. The local economy consumed about 400,000 b/d; thus oil exports totalled 9 million b/d. We are estimating that service payments and private transfers increased to $6.5 billion. A 6.5% annual rate of return is assumed on SAMA foreign assets. Net investment income is estimated at $2.4 billion.

Treasury is estimating a Saudi current account surplus of $10 billion for 1978. The CIA has estimated Saudi oil production at 8.5 million b/d, a decline of 900,000 b/d over the 1977 level. Local consumption is again estimated at 400,000 b/d; thus oil exports are expected to be 8.1 million b/d. The lower export levels translate into oil revenues of $35.6 billion, a $3 billion decline from 1977.

At the same time imports are expected to increase by 25% or $3.5 billion to almost $18 billion. Increased service payments and private transfers are not totally offset by an increase in net investment income to $2.9 billion. Accordingly net services and private transfers increase by $1.2 in 1978.

<u>Composition of Current Account Changes 1977/1978</u>

	$ Change (Billion)
Oil Revenues	$-3.1
Imports	+3.6
Services and Private Transfers, net	-1.2
TOTAL CHANGE	$-7.9

The above mentioned changes in the 1978 Saudi current figures explain the $8 billion decline in the 1978 surplus over the 1977 balance.

Office of Saudi Arabian Affairs April 6, 1978

DECLASSIFIED
AUTHORITY: [illegible]
DATE: 9/10/79

SAUDI ARABIA
CURRENT ACCOUNT BALANCE ESTIMATES
($ Billions)

	1976 1/	1977	1978
Exports	34.0	38.8	35.7
Oil (Gov't Take)	33.9	38.7	35.6
Non Oil (fob)	.1	.1	.1
Imports (fob) 2/	10.8	14.3	17.9
Trade Balance	23.2	24.5	17.8
Services & Private			
Transfers, net	-5.7	-6.3	-7.5
Freight & Insurance 3/	-3.0	-2.6	-2.7
Investment Income 4/	+1.9	+2.4	+2.9
Local Cost of Oil Production	+.4	+.4	+.4
Other 5/	-5.0	-6.5	-8.1
Current Account Balance (excludes official transfers)	17.5	18.2	10.3

Office of Saudi Arabian Affairs — April 5, 1978

FOOTNOTES

1/ 1976 figures are consistent with the IMF Balance of Payments Yearbook

2/ Imports are projected to increase by 25% in 1978.

3/ Freight and insurance is 27% of imports in 1976, 18% in 1977, and 15% in 1978.

4/ A 6.5% annual rate of return is assumed on SAMA foreign assets.

5/ Other services and private transfers are assumed to increase at the same rate as imports.

Office of Saudi Arabian Affairs April 5, 1978

TREASURY DEPARTMENT

No. E-10

SUMMARY OF MEMORANDUM

DATE: Fall 1977

TO: High Level Treasury Official

FROM: High Level Treasury Official

SUBJECT: Saudi Options in Foreign Exchange Markets

In my memorandum of October 1977, entitled "Currency Composition of Saudi Financial Assets", it was reported that statistical evidence and market observations do not indicate that the Saudis have so far made significant moves to diversify the foreign currency composition of their financial assets, which are believed to be predominantly dollar-denominated. As an addendum to that memorandum, it may be useful to examine options available to the Saudis if they should become uncomfortable with the dollar concentration of their portfolio.

In our view, Saudi options are limited. The sheer size of their portfolio would make it difficult or impossible for them to transfer any large proportion of their financial assets into another currency, and any such moves would, we believe, have to be made on the margin, slowly and carefully. Moreover, there is no yield incentive to do so.

It has been estimated that Saudi dollar-denominated assets are about % of their portfolio; this would mean about $ Billion out of the $53.2 Billion April 1977 figure. It is probably safe to say that an upper limit on the amount that exchange markets could absorb from all sources over a period of two weeks to two months would be about $5 to $10 billion; amounts on this order of magnitude in similar time spans closed down the exchange markets in 1971 and 1973, and would probably do so again. The Saudis themselves could not move such large amounts in such periods of time, since moves of smaller amounts on their part would undoubtedly drive rates for the chosen currencies up sufficiently to precipitate defensive runs into those currencies by others. Such moves by others would be necessitated by considerations of self-defense as firms saw their trade liabilities in those currencies rapidly appreciating, and as their trade assets in dollars (much of the world's outstanding trade credits are denominated in dollars) depreciated.

Assuming that the transfer into other currencies of as much as $3 to $5 billion of Saudi assets could be sucessfully executed over a period of several months, the next question Saudi managers would have to confront would be that of investment vehicles. The only currencies (and economies) providing any feasible portfolio investment alternatives would be yen, marks, and perhaps sterling; the Swiss have already demonstrated a limited capacity for absorption of dollar investments (the 1973 currency crisis began when the Swiss were overwhelmed by a mere $200 million).

Interest rates on short-term yen, mark, sterling, and Swiss investments of the sort favored by the Saudis are all below the present rates of return on dollar instruments, and this yield differential could only be widened by any significant buying of such investments by the Saudis. The stock and bond market opportunities in the yen, mark, and sterling economies are limited, and investment return would undoubtedly be reduced by heavy Saudi buying.

Probably one of the more satisfactory choices for currency diversification would be direct investment. This option also opens up other currencies than the three or four principal currencies so far discussed. There have indeed already been several fairly widely publicized cases of OPEC direct investment, such as the Iranian purchase of an interest in Krupp and the Libyan investment in Fiat.

In the final analysis, the Saudis are in a position not unlike that of an American investor in that they operate essentially in a dollar environment, as pointed out in the October memorandum. The real "currency risk" for them, therefore, is not so much a foreign exchange risk as an inflation risk. In addressing their problem in these terms, the Saudis may reach an investment posture similar to that of an American inflation-avoiding yield seeker: to seek investment in real assets, including commodities such as oil. Such a policy would lead to three courses of action: foreign direct investment, domestic direct investment, and oil production and pricing policies which would be different than their present policies.

The Saudis have already embarked on an ambitious domestic direct investment program which has tended to slow their accumulation of financial assets. They have also embarked on a significant direct investment program, particularly in the real estate field. Oil price indexation seems effectively to be a fact of life in the annual OPEC pricing reviews; pricing in SDRs would be a variant of such an approach. The policy of keeping oil in the ground as an inflation hedge has been discussed in Saudi Arabia, and for the time being has been rejected.

TREASURY DEPARTMENT

No. E-9

SUMMARY OF MEMORANDUM

Date: October 1977

Subject: Currency Composition of Saudi Financial Assets

To: High Level Treasury Official

From: Treasury Official

The consensus in the Washington international financial community (several Federal agencies) is that the Saudis have not made any significant moves to diversify their international financial assets out of the dollar. A similar market view was reported in the Journal of Commerce on Friday, October 7 (a copy of this article is attached).

A statistical analysis of available (but incomplete) data on Saudi holdings shows that their claims on the head offices of U.S. banks and their holdings of long-term U.S. Treasury and agency bonds and noters increased from * % of their January 1975 international reserves of * % to % in May 1976, fluctuated irregularly downward to % in October 1976, rose again to % in May 1977, and were % of the August 1977 figure of $,the most recent available data.**

While these data do not by any means cover the entire spectrum of potential placements of Saudi assets, they serve as a reasonable proxy for an important part of their assets. In general trend they appear to support the CIA view that the dollar component of Saudi financial assets increased from $ in 1974 to $ in 1975, holding steady at that level since then.**

* Material deleted from original document.
** Material deleted from original document.

A broader view of Saudi financial assets gives us a fuzzier picture, but one which does not seem to contradict our basic impression. In addition to the international reserves figure, which was $28.2 billion in August and $27.8 billion in April 1977, IMF reports $25.4 billion of "SAMA other assets" as of April 1977 (no more recent figures are available); this is essentially an investment portfolio, and with the official reserves figure brings the total of Saudi international financial assets (to which estimate applies**) to $53.2 billion as of April 1977. The component of this larger figure which is demonstrably dollar-denominated consists of Saudi claims on U.S. banks and holdings of Treasury and agency bonds and notes, already mentioned above -- essentially reserve-type assets and in addition U.S. corporate securities and Eurodollar deposits with U.S. banks' foreign branches. This known dollar component of the larger picture increased from % of the September 1975 figure of in September 1976, eased back to % in December 11976, and was % of the March 1977 figure of $ the most recent figure available.**

These figures of course do not cover the Eurodollar deposits made with non-U.S. banks, and it would be possible for a significant shift out of dollars to be taking place in this part of the Eurodollar market without our having any statistical evidence of it. Moreover, we have only incomplete data for the period since March. However, given the amounts involved, it seems unlikely that any concerted policy of currency diversification by the Saudis would remain unnoticed by the market for long. We have found foreign exchange traders to be sensitive to central bank interventions of $20 to $50 million, and are sure that the market opinion reported by the Journal of Commerce article is fairly accurate. We also note that the daily foreign exchange market reports of the Office of Foreign Exchange Operations, which reflect the views of the New York Fed foreign department, have reported nothing of this sort going on.

** Material deleted from original document.

The foregoing discussion covers the evidence which is available to us, all of which seems to be negative. If we go beyond the evidence to an *a priori* analysis, we reach a similar conclusion. The Saudi riyal is tied to the dollar, so that any weakness in the dollar is also a weakness in the riyal, and vice versa. Saudi revenues are dollar revenues, paid by U.S. firms in the form of dollar checks drawn on U.S. banks. Saudi imports are significantly denominated in dollars. Their imports from Japan, Germany, France and the U.K. are outweighed by their exports to those countries; the only significant hard currency exposure they had in 1976 was a $249 million negative balance of trade with Switzerland.

While there is thus little foreign currency risk for the Saudis in holding dollars, there are significant advantages to them as portfolio managers in operating in the U.S. currency. The $53.7 billion portfolio they manage is one of the largest in the world, comparable to the assets of a Prudential Insurance or a Bank of America. Managers of smaller U.K. and Swiss investment portfolios, facing portfolio management problems of smaller magnitude, have found it necessary to invest as much as 40% of their portfolios in dollars, simply because no other market provides the depth and breadth necessary for large-scale portfolio operations.

In sum, it would appear that the Saudis have relatively little reason to diversify out of the dollar, and substantial reasons for operating principally in this currency; in addition, there is no discernable statistical evidence or market comment suggesting that they are seeking to reduce their dollar holdings.

C. KUWAITI SURPLUSES, INVESTMENTS, AND FINANCIAL STRATEGIES

Kuwait Oil Profits Buy $7 Billion Worth of U.S. Securities

DAN DORFMAN

Kuwait, the second-largest oil producer in the Organization of Petroleum Exporting Countries, has amassed huge blocks of American securities now worth close to $7 billion. And if Kuwait's American adviser on U.S. securities, Citibank, has its way, the amount could swell to roughly $8 billion before the end of the year.

Confidential documents have been obtained by the Chicago Tribune that detail for the very first time an OPEC nation's broad-based holdings in the United States. They dispute the repeated statements of Treasury and other government officials that OPEC's petro-billions invested in the United States are going primarily into short-term money market securities, such as Treasury bills.

They also raise serious questions as to the extent of the equity holdings of the other 12 OPEC producers, including Saudi Arabia, the biggest oil exporter of them all.

The documents reveal that Kuwait — which had petro revenues last year of $18.6 billion — has acquired from 1 percent to over 2 percent of the common shares of a slew of the biggest U.S. companies including Dow Chemical, J.C. Penney, McDonald's, Honeywell, Burroughs, General Mills, K mart, Burlington Industries, Ralston Purina, Associated Dry Goods Corp. and Kerr-McGee.

The documents, which also detail private meetings between Citibank and Kuwaiti officials, reveal that the OPEC producer is unhappy with that bank's management of its funds and has threatened to shift its assets to another bank. Essentially, it wants Citibank to trade the equity market more aggressively — to generate more capital gains.

Considering the Kuwaiti billions in the marketplace, a more aggressive investment strategy — if adhered to by Citibank — clearly could be a destructive force. It would add considerable more volatility to an already volatile stock market.

Included in the documents obtained by the Tribune is a complete breakdown of two of the largest Kuwaiti equity accounts managed by Citibank — the Earmarked and Reserve portfolios (which are detailed in an accompanying chart). The holdings are as of last April 4. Their asset values, though, are based on stock prices as of last December, and stood at $2.47 billion — about a $317 million increase from the cost of the stocks.

All told, Citibank manages five equity portfolios for Kuwait, which, as of last Nov. 28, carried a market value of approximately $3.7 billion. Another $3.3 billion was in bonds and short-term securities. Plans call for this portfolio, which contains about $440 million of Canadian equities and bonds, to be increased to over $8 billion by December.

To guard the identity of the owner of these equities, some of which are stored in Citibank branches in London and Nassau, Citibank lists the Kuwaiti holdings in a secretly coded "M" account.

An examination of Kuwait's equity holdings in the United States — which cover the bread-and-butter of corporate America — shows ownership in 15 U.S. banks. These include interests in Bank of America, Chase Manhattan, Mellon National Corp. and Continental Illinois. Kuwait's biggest interest in a bank — 2.2 percent — is held in the Pittsburgh National Bank

The Kuwaitis also are using their surging oil revenues to buy up sizable chunks of the most important U.S. energy companies. In fact, more than 22 percent of their two biggest portfolios is centered in oil and oil-service companies. Included are over 1.8 million shares of Atlantic Richfield, more than 1.2 million shares of Phillips Petroleum and over 1 million shares of Conoco.

Ma Bell is another favorite of the Kuwaitis. The Citibank documents show they shelled out nearly $100 million to buy close to 1.8 million shares of American Telephone & Telegraph.

Peter Vermilye, Citibank's chief investment officer, declined to talk about the Kuwaiti investments. "We don't talk about our clients' affairs, including Kuwait, and there's no more sensitive account than that one," he said.

Vermilye's concern is understandable since Kuwait — by the virtue of its assets — is undoubtedly one of the biggest, if not the biggest, of Citibank's investment accounts. Its total holdings with Citibank — which is not its only adviser on U.S. investments — probably place it among the top five mutual funds in the country (excluding money market funds).

One Citibank memo, focusing on the size

See DORFMAN, E3

THE WASHINGTON POST Sunday, May 31, 1981 E3

Do Kuwait's Petro-Billions Hurt or Help the U.S. Economy?

DORFMAN, From E1

of Kuwait's investments for the 12 months ending June 30, 1980, notes the following:

● A total of almost $1.25 billion of interests and dividends was earned in the past year.

● Nearly $33 billion of funds were transferred in and out of accounts.

● More than $100 billion of securities transactions were completed during the past year.

These add up to huge management fees from Kuwait, as does its rapid acceleration of U.S. investments, which amounted to only $540 million at the end of 1974.

The greatly accelerated U.S. equity purchases by Kuwait — and that's only one OPEC member — again raises the obvious question of whether there's a genuine danger of the oil-exporting nations' gaining control, or, at the very least, a strong influence, over some of the leading U.S. companies.

Paul Erdman, author of "The Crash of '79", and an expert on Mideast affairs, views the Kuwaiti investments as positive. Even though the Kuwaitis are insisting on aggressive trading, they're still making a long-term bet on corporate United States, he said. "And the fact they're working with Citibank, rather than through a Swiss account or a hot-shot Caribbean bank, shows they're being responsible." He said he expects Kuwait always to stay below the 5 percent level in individual U.S. equity investments, so as to avoid making a public announcement.

Acquiring of a position of 5 percent, or more, of a publicly owned company's shares requires a public filing with the Securities and Exchange Commission.

Erdman's lack of concern is not shared by Rep. Benjamin Rosenthal (D-N.Y.), chairman of the Commerce, Consumer and Monetary Affairs subcommittee, which held hearings in 1979 on foreign investments in the United States.

"I'm deeply concerned about OPEC investments in the United States," said Rosenthal, whose committee will resume hearings in July. "The Treasury's data collection is absolutely inadequate," he said. "We could have OPEC countries buying up huge pieces of America without anyone knowing it . . . and there's nothing to arrest it. It's frightening."

Rosenthal said he plans to push for new laws to require that every foreign investment in the United States — regardless of how small — be duly reported to both the Treasury Department and the Department of Commerce.

"We need an intelligent inventory of the amount of U.S. assets that are being acquired abroad," he said. "Foreign investments may be good for us — but not if they lead to foreign domination."

An Inside Look At Where Kuwait Invests Its Billions

	Holding in 100s	Market Value	Cost	% of Portfolio Shares
AUTOS-DURABLES				
Black & Decker	1,461	3,487,737	4,008,494	0.14
Eaton Corp	32	120,000	104,825	0.00
Firestone T-R	6,990	8,737,500	7,174,362	0.35
General Motors	4,927	26,051,512	24,429,030	1.05
Goodyear T-R	7,609	15,122,887	12,106,370	0.61
Sealed Power	400	1,081,375	687,500	0.04
FOREST PRODUCTS				
Ga-Pacific	5,600	17,220,750	14,619,250	0.70
Weyerhaeuser	11,461	48,186,375	31,123,590	1.83
CHEMICALS				
Dow Chem Co	11,349	43,409,925	52,420,035	1.76
DuPont	7,498	37,115,100	32,552,118	1.50
Economics Lab	1,025	3,494,812	4,721,462	0.14
FMC Corp	800	2,899,750	1,993,400	0.12
Grace (WR)	788	4,018,800	2,783,234	0.16
Lubrizol Corp	1,843	11,116,125	7,167,892	0.45
Rohm & Haas	590	3,422,000	3,957,081	0.14
Williams Co.	622	2,278,075	1,898,082	0.09
MISCELLANEOUS NONDURABLES				
Burlington Ind	4,712	10,109,700	9,968,735	0.41
Chesebro-Ponds	6,027	20,841,125	17,235,099	0.82
Colgate-Palmolive	3,019	4,830,400	4,526,144	0.20
Eastman Kodak	7,494	61,076,100	73,798,621	2.47
Int Flav-Frag	5,572	11,561,900	14,609,644	0.47
Procter & Gamble	7,883	55,575,150	71,525,249	2.25
Stevens, J.P.	1,435	2,080,750	2,238,589	0.08
ELECTRONICS				
AMP Inc	1,000	5,500,000	3,334,654	0.22
Hewlett-Packard	3,000	27,750,000	13,643,206	1.12
Intel Corp.	1,000	3,685,000	3,936,697	0.15
Perkin-Elmer	578	1,734,000	1,961,117	0.07
Texas Instruments	470	5,487,250	3,775,969	0.22
FINANCE-BANKS				
Arizona Bank	1,139	1,914,867	1,901,850	0.08
BankAmerica Corp	3,379	9,081,062	6,458,334	0.37
Bankers Trust	1,440	4,520,541	2,844,490	0.18
Chase Manhattan	1,377	6,230,925	4,548,245	0.26
Cont Illinois	2,276	7,994,480	6,035,601	0.32
Dominion Bkshrs	430	612,750	658,225	0.02
1st Ala Bancshrs	300	825,000	772,500	0.03
1st Bank System	1,500	6,412,500	5,561,000	0.26
Bank System	1,500	6,412,500	5,561,000	0.26
1st Comm Corp	250	693,750	600,000	0.03
1st Intl Bancshr	1,527	8,169,450	5,269,677	0.33
1st N.M. Bkshrs	170	301,750	315,446	0.01
1st Ohio Bancorp	100	225,000	191,250	0.01
Mfrs Hanover	1,750	5,687,500	6,095,800	0.23
Mellon Nat'l	1,570	5,612,750	4,477,556	0.23
Pittsburgh Nat'l	1,370	6,610,250	5,729,030	0.27
S.Carolina Nat'l	100	220,000	193,800	0.01
Wachovia Corp	335	1,183,687	946,300	0.05
FINANCE-INSURANCE				
Aetna Life & Cas	980	3,324,750	2,903,935	0.13
American Express	3,680	23,363,887	20,061,650	1.03
Crum & Forster	440	1,287,000	1,047,501	0.05
Federal Natl Mtg	4,913	5,465,712	8,165,589	0.22
Gen Re Corp	2,377	14,975,100	8,739,209	0.61
Northwestern Natl	654	1,912,950	2,248,184	0.08
FOOD-BEV-TOBACCO				
Arc-Dan-Midl	2,527	5,086,593	5,789,844	0.21
Beatrice Foods	10,624	21,380,880	25,700,183	0.87
Carnation Co	3,134	14,888,400	18,699,314	0.60
General Mills	8,864	29,583,600	24,419,478	1.20
Morris, Philip	2,368	12,106,400	6,221,792	0.49
Nabisco Inc	470	1,415,875	1,131,589	0.06
PepsiCo Inc	650	2,183,125	1,303,250	0.09
R.J.Reynolds Ind	500	2,225,000	2,362,125	0.09
Ralston Pur	24,441	32,384,325	38,090,089	1.31
Standard Brands	4,330	12,557,000	13,640,383	0.51
HEALTH				
Am Home Products	15,350	51,806,250	52,725,487	2.10
Bxtr Trv Labs	5,926	34,815,250	23,352,620	1.41
Eli Lilly Co	7,056	45,423,000	42,320,669	1.84
Hosp Corp Am	3,445	13,566,666	11,824,427	0.56
Humana Inc	640	2,696,000	2,181,490	0.11
Johnson & Johnson	4,712	8,887,000	41,773,341	3.98
Merck & Co	5,808	49,150,200	42,256,877	1.99
Schering-Plough	8,208	29,446,200	42,473,098	1.19
Squibb Corp	3,146	10,303,150	10,082,082	0.42
INFORMATION PROCESSING				
Apple Computer	1,945	4,765,250	4,609,566	0.19
Auto Data Proc	1,510	8,493,750	3,766,276	0.34
Burroughs Corp.	6,552	34,479,900	31,357,706	1.40
Comp Sciences	1,585	2,872,812	3,088,651	0.12
Computervision	1,376	11,283,200	9,781,211	0.46
Control Data	803	5,530,662	4,238,932	0.22
Data General	1,250	6,953,125	8,334,343	0.28
Datapoint Corp	1,160	6,351,000	3,727,244	0.26
Digital Equip	3,463	31,079,000	46,482,369	2.07
Honeywell	4,064	42,567,000	33,303,965	1.72
IBM	6,040	37,674,300	33,874,934	1.58
Tandem Comp	1,100	8,305,000	7,514,532	0.34
Wang Labs	1,057	4,215,864	2,071,101	0.17
FOOD SERVICE				
McDonalds	7,359	46,177,725	40,533,114	1.87
MACHINERY-ELECTRICAL				
Allis-Chalmers	1,000	3,162,500	3,385,106	0.13
Caterpillar	4,192	27,094,601	22,461,850	1.10
CBI Indus	1,247	6,172,650	3,080,001	0.25
Cooper Indus	2,350	11,573,750	12,304,574	0.47
Crouse Hinds	2,348	8,138,126	8,277,016	0.33
Deere & Co.	1,000	4,612,500	4,308,564	0.19
General Electric	7,885	52,839,508	41,361,453	2.14
Ill. Tool Works	376	1,118,600	903,777	0.05
Ingersoll Rand	1,979	14,570,387	14,452,353	0.59
Joy Mfg Co	800	4,080,000	4,360,522	0.20
McGraw-Edison Co	20	87,500	78,200	0.00
Norton Co	978	4,547,500	5,297,480	0.18
Rexnord Corp	249	794,912	854,075	0.03
Sundstrand Corp	350	1,838,750	1,742,390	0.67
Wheelabrator-Frye	1,250	7,015,625	6,396,924	0.28
METALS				
Aluminum Co of Amer	930	3,255,000	2,570,863	0.13
Amax Inc	1,849	11,952,393	4,600,237	0.48
Cleveland-Cliffs	1,637	6,548,482	4,744,231	0.27
East Gas Fuel	2,180	5,886,000	3,106,405	0.24
Freeport Min	1,735	12,426,937	10,996,494	0.50
Kennecott Corp	1,000	5,537,500	3,976,543	0.22
Newmont Mining	746	4,625,200	3,900,385	0.19
Pittston Co.	3,124	8,122,400	3,869,832	0.33
St Joe Minerals	1,396	7,329,000	7,797,304	0.30
Texasgulf Inc	730	4,106,250	3,557,288	0.17
Westmoreland Coal	389	1,487,225	1,382,085	0.06
OIL SERVICE				
Halliburton	3,080	23,408,000	8,146,089	0.95
Hughes Tool Co	140	1,282,500	1,000,000	0.05
McDermott	3,463	13,159,400	6,364,209	0.52
Santa Fe Int'l.	418	1,015,687	999,980	0.04
Schlumberger	5,000	50,845,609	11,974,423	2.06
Western Co of N.A.	266	1,493,332	500,000	0.06
OILS				
Amerada Hess	3,257	11,725,300	13,222,756	0.47
Atlantic Richfield	10,882	96,060,625	43,136,204	3.89
Conoco Inc	10,504	59,478,900	33,704,878	2.41
Exxon Corp	1,476	10,129,050	7,705,080	0.41
Gen'l Amer. Oil	2,064	8,566,098	7,633,100	0.35
Getty Oil Co	2,077	15,265,950	16,064,633	0.62
Kerr-McGee	3,751	29,177,137	27,238,199	1.18
Mobil Corp	2,000	13,075,000	15,789,249	0.53
Pennzoil Co	534	2,423,025	1,893,959	0.10
Permian Basin Rty	680	1,030,000	468,199	0.04
Phillips Petro	12,482	58,971,300	35,863,867	2.39
Sabine Corp	300	3,043,750	1,080,000	0.12
San Juan Basin Rty	600	772,500	322,225	0.03
Southland Rty Co	600	1,890,000	803,174	0.08
Std. Oil Ind	3,412	25,163,500	9,150,610	1.02
Std. Oil Cal	4,980	38,595,000	12,219,390	0.88
Std. Oil Ohio	8,482	45,245,300	15,382,924	1.83
Sup Oil Co	2,105	46,573,125	26,942,670	1.89
Transco Cos	44	198,000	124,925	0.01
Union Oil, Cal	2,087	8,099,437	8,344,487	0.33
RETAIL SALES				
Asc Dry Goods	3,511	10,752,437	6,917,640	0.44
Eckerd, Jack	1,933	7,707,837	6,237,382	0.31
Federated Dept Strs	6,673	25,524,225	34,254,374	1.08
K mart Corp	16,791	32,742,450	53,484,896	1.33
May Dept Stores	3,833	10,923,475	12,037,745	0.44
Penney	10,880	28,932,750	46,335,368	1.17
Tandy Corp	1,000	5,975,000	4,267,128	0.24
Woolworth	1,670	4,404,625	3,895,090	0.18
TRANSPORTATION				
Burlington North	1,409	9,538,903	4,341,480	0.39
CSX Corp	1,351	7,302,656	3,726,497	0.30
Cons Frt	1,321	5,741,775	3,544,911	0.33
Overnite Trans.	190	760,000	448,448	0.03
Union Pacific	5,000	37,000,000	13,567,451	1.50
Yellow Frt. Syst	2,480	4,287,500	4,038,000	0.17
UTILITIES				
Am Elec Pow	1,234	2,006,314	2,461,346	0.08
AT&T	17,742	91,375,268	98,648,075	3.70
Ariz. Pub. Serv.	1,030	1,712,375	2,084,250	0.07
Balto.Gas & Elec	350	1,223,750	1,480,375	0.05
Ctrl &So West	3,595	4,853,250	5,463,214	0.20
Cen Ill Pub	1,300	1,393,750	2,043,750	0.06
Cleveland Elec	1,250	1,953,125	2,421,875	0.08
Commonw Edison	1,795	3,410,500	4,499,552	0.14
Cons Power	1,300	2,568,750	3,315,500	0.10
Detroit Edison	1,300	1,762,500	2,456,280	0.07
Duke Power Co	900	1,631,250	1,699,850	0.07
Fla P&L	1,350	4,126,875	3,910,978	0.17
Houston Nat Gas	1,000	5,025,000	4,066,067	0.20
Illinois Power	1,484	3,101,250	3,536,924	0.13
K.C. P&L	1,000	2,025,000	2,500,000	0.08
Kan. P&L	1,270	2,174,875	2,619,375	0.09
Mid. South Utils	3,615	4,292,812	5,067,187	0.17
Ohio Gas & El	1,400	1,930,375	2,275,375	0.08
Pac Gas & Elec	1,000	2,129,250	2,224,420	0.09
Pnhndl EastPL	1,300	6,375,000	3,959,423	0.26
Phila. Electric	1,000	1,212,500	1,843,380	0.08
Public Sv N.M.	1,280	2,671,875	2,485,786	0.11
Public Sv Colo.	578	838,100	640,286	0.08
Public Sv Ind.	1,500	2,962,500	2,784,000	0.12
Pub Sv El&Gas	1,250	2,250,000	2,843,700	0.09
So Carolina Elec	870	1,163,625	1,486,500	0.06
S Cal Edison	2,285	8,726,312	3,726,142	0.23
Southern Co.	800	970,000	1,304,800	0.04
So Nat Resources	498	4,676,400	2,005,500	0.19
Tenneco Inc	785	3,738,562	2,395,216	0.15
Texas Eastern	2,000	11,300,000	12,104,000	0.46
Texas Utilities	500	875,000	904,250	0.04
United En.Resrcs	484	1,872,750	1,888,386	0.08
United Telecom	1,300	2,242,500	1,706,200	0.09
Utah P&L	1,250	2,078,125	2,227,500	0.08
Vepco	775	882,187	819,400	0.05
COMMON STOCK-MISC				
Cessna Aircraft	1,027	2,383,312	2,466,475	0.14
City Investing	1,000	2,612,500	2,227,598	0.11
Galco Corp	280	604,375	395,372	0.03
General Dynamics	300	1,470,000	1,641,750	0.07
Litton Indus	389	2,848,075	2,790,880	0.12
Martin Marietta	1,000	4,800,000	4,747,598	0.28
McDonnell Dough	300	2,218,750	2,288,950	0.09
Mesa Rty Trust	400	1,390,000	1,359,288	0.06
Minn. Mining & Mfg	7,618	48,088,625	43,296,448	1.95
United Tech.	1,000	5,625,000	5,587,750	0.23
MUTUAL FUNDS				
Japan Fund Inc	787	737,812	190,372	0.03

H4 Sunday, June 7, 1981 THE WASHINGTON POST

DAN DORFMAN

Kuwait Puts Citibank on Investment Hot Seat

Citibank is on the hot seat. It has a choice between being an imprudent banker or losing its biggest investment account — Kuwait, the second-largest oil producer in the Organization of Petroleum Exporting Countries (OPEC). And the fallout could be a far more explosive and volatile stock market for the nation's nearly 30 million investors.

Confidential documents obtained by Chicago Tribune reveal that top officials in Kuwait — which has entrusted Citibank with the management of close to $7 billion worth of U.S. securities — are demanding a bold new investment strategy that would turn the bank into one of the most aggressive and biggest stock market traders in the United States. In brief, the OPEC producer — with $18.6 billion of petro-revenues last year — is insisting that sizable chunks of one of the largest pools of money in the world actively trade in and out of U.S. stocks as they go up and down.

"We want more gains," Citibank is being told by Kuwait, which is unhappy with the bank's performance.

An internal Citibank memo — covering meetings held last December between Kuwaiti and Citibank officials — indicates that the bank is ready to accede to Kuwait's demands, which are described by one market expert as "irrational."

At one meeting (held in Kuwait), Shaikh Salem Abdullah al-Ahmed al-Sabah, the head of American investments for Kuwait and a member of the country's royal family, put it bluntly to Peter Vermilye, Citibank's chief investment officer: Can the bank adjust to a "buy today and sell tomorrow" investment strategy?

More specifically, Shaikh Salem wanted to know if Citibank could adopt a strategy — which, he said, was being engineered successfully by the Kuwait investment office in London — of trading 10,000-share blocks of stocks that move up and down within a 2- to 3-point range in a given week. The idea would be to sell at the high and buy the block back when the security dropped 2 to 3 points.

The memo, written by Citibank vice president John J. Klein, reported that another Kuwaiti investment official — in an equally bold recommendation — suggested trading 5 percent of each large holding on a weekly basis.

(Both suggestions — if they came to pass — would surely accelerate ulcer-producing yo-yo moves in the marketplace).

Shaikh Salem, repeatedly expressing displeasure with Citibank's investment staff for lack of a more aggressive trading posture, heatedly warned the bank's officials that "if nobody is listening, Citi will lose out." He added: "Tell us if you think we're crazy."

In response, Vermilye promised that the bank (which obviously gets huge fees from Kuwait) will be much more active in '81.

The revelation of Kuwait's strong demands on Citibank comes on the heels of earlier disclosures by the Tribune that the big oil exporter had acquired from 1 to over 2 percent of some of the United States' biggest companies — including K-mart, McDonald's, J.C. Penney, Burroughs and General Mills.

As of Last Nov. 28, almost $3.7 billion or 52 percent of Kuwait's securities holdings under Citibank management were in stocks. Additional Citibank documents suggest a much bigger Kuwaiti push on equities — a position of over $4.8 billion, or 60 percent of the portfolio, by December.

Several Wall Street money men tell me Kuwait's insistence on more aggressive trading of its billions would clearly have a destabilizing impact on an already volatile U.S. market. They argue that Citibank's investment philosophy, which is longer-term oriented, is simply not geared to the in-and-out trading suggested by Kuwaiti officials.

Doubts also are voiced as to whether Citibank — or any investment biggie, for that matter — is capable of successfully trading hundreds of millions of dollars in the marketplace on a round-the-clock basis.

Monte J. Gordon, head of research at money-management giant Dreyfus Corp., says Kuwait's investment strategy "borders on the irrational." Kuwait essentially is suggesting that turnover means profit . . . "and that's crazy," he adds. He observes that Kuwait is advocating a turnover rate for its stock portfolios of every 20 weeks . . . "which is way out of sight." It would make Citibank more aggressive than the most aggressive mutual fund, he tells me.

To adhere to such a strategy, Citibank, says Gordon, would have to change totally the character of its investment positions. It would be forced to focus on the things that bounce all over the place — fast-moving drug stocks, the speculative defense issues and technology. And what happens, Gordon asks, if we enter a period of a declining market? "I just don't think Citibank can do it . . ."

32 THE WALL STREET JOURNAL, Tuesday, September 15, 1981

Bankers Say Kuwait Spurned Citibank, Shifting $4 Billion to Morgan Stanley

From Tim Carrington in New York, R. Mohan in Kuwait and E.S. Browning in Hong Kong.

When multibillion-dollar fortunes get moved around, they generally create a stir.

A case in point is a major reshuffling of as much as $7 billion in Kuwaiti assets. Although the Middle Eastern country's government hasn't announced any such moves, bankers from Kuwait to New York are abuzz with reports that Morgan Stanley & Co. picked up about $4 billion of the gargantuan investment account and that Chemical Bank is in line to manage the remainder. The loser, if the reports are accurate, is Citibank. Bankers say the Kuwaitis were rankled by what they felt was a lukewarm investment performance at the bank. A series of leaks to the news media about the account also bothered the Kuwaitis, bankers report.

None of the New York financial institutions involved in the reports will comment. But investment bankers in London and New York say Morgan Stanley scored a coup by capturing the hefty investment business of the Kuwaitis. Although well-known as an underwriter and investment banker, Morgan Stanley's money-management arm is dwarfed in size by the portfolio operations at the large New York banks and the biggest insurance companies. Around June, Morgan Stanley's investment-management unit, Morgan Stanley Asset Management Inc., handled assets valued at just more than $1 billion. That compares to about $35.6 billion under management at the Morgan Guaranty Trust Co. and $23.5 billion at Citibank at the end of 1980. The Kuwaiti funds would quintuple the assets managed by Morgan Stanley.

Credit Lines

While Morgan Stanley isn't one of the largest money-managers as measured by total assets, it has generally gotten good marks on its performance. And through its powerful position as lead underwriter for billions of dollars in securities offerings each year, Morgan Stanley is perceived as being close to the pulse of the capital markets.

Among Friends

Morgan Stanley also has ties that could have helped land the Kuwait business. The firm has done business with Kuwait and other Middle Eastern countries over the last 20 years. Moreover, William Black, chairman of Morgan Stanley International Inc., and Richard Debs, president of that unit, are friends of the present Kuwaiti finance minister, Abdul Latif al Hamad.

According to the bankers in Kuwait, the transfer of the remaining assets, valued at some $3 billion, to Chemical Bank isn't nailed down, and Citicorp is fighting a last-ditch battle to keep at least a portion of the massive account under its wing.

Rumblings of dissatisfaction were heard this summer in the New York financial community, leading Citicorp's competitors to view the Kuwaiti funds as up for grabs. In July, Kuwait's parliament criticized what it called the "unimaginative kind of investment government is making of its surpluses." Several members of the Kuwaiti parliament took exception to the fact that a U.S. bank was managing the portfolio.

Finance Minister Hamad, answered the debate by saying that the government would soon establish an autonomous body for investing government surpluses. Bankers in Kuwait say such an agency will soon be set up and that in about five years, it will take over management of the country's portfolio.

Kuwait press reports have quoted Finance and Planning Ministry Undersecretary Abdul Lohsin al Huneif as saying the government's income from its world-wide investments was estimated at $5.7 billion last year, compared with oil income of some $12 billion in 1980. For 1981, Kuwait expects its investment income to be about $8 billion, almost equal to income from this year's depressed oil market.

Kuwaiti banking sources say that the new head of the Finance Ministry, Mr. Hamad, was assigned to increase the profitability of Kuwaiti investments when he was appointed to succeed Abdul Rahman al Ateeqi a few months ago. Mr. Ateeqi was said to have close ties to Citibank. Although he still serves as a government adviser, he hasn't any control over the Finance Ministry.

Philippine Loan Clinched

A $180 million syndicated loan for the Philippine central bank has been virtually completed, according to BT Asia Ltd., the Hong Kong investment banking arm of Bankers Trust Co. of New York, which is coordinating the loan. About $55 million was raised by lead managers to provide about $11 million each. The loan is to be signed early in October.

"I'm sure they had to beat the bushes" to pull in so many banks, says one banker who wasn't involved. But, adds this banker, "that's a pretty good outcome." The central bank continues to attract funds at interest terms more favorable than those it was receiving at the start of this year.

Bankers say the central bank has been reluctant to take another big medium-term loan because Philippine banks and companies, to which the central bank usually relends the money, don't want to borrow at today's high interest rates. The central bank currently has more medium-term funds than its customers want, these bankers say.

WALL STREET JOURNAL 10-9-79

Power Broker

Kuwait's Money Man Favors U.S. and Stocks In Placing Oil Billions

How Khaled Abu Su'ud Picks His Nation's Investments; $20 Billion for Uncle Sam

His Advice: Don't Buy Gold

By Bill Paul

Staff Reporter of The Wall Street Journal

KUWAIT—At precisely 11:52 a.m., the telephone rings in the palace office of Khaled Abu Su'ud, investment and financial adviser to the Emir of Kuwait. The caller has good news: The dollar is showing signs of strength on international markets. That means that the Kuwaiti government, which holds billions of U.S. dollars, has a reprieve, albeit slight, from the dollar's steep two-year decline.

"Fantastic," shouts Mr. Abu Su'ud as he hangs up the phone and hurries down a sparkling marble hallway. "I must tell the Emir the good news before he goes to noon prayers."

Such is a typical moment in the life of one of Islam's most influential money men. For much of his working day, the 53-year-old Mr. Abu Su'ud shuttles back and forth between the Emir's office and the office of the prime minister, who is the Emir's brother. It is Mr. Abu Su'ud's job to keep them informed of the latest currency changes, investment opportunities and important world financial developments. Back in his office overlooking the blue-green water of the Persian Gulf, he reviews telex messages from Western banks and he counsels such Kuwaiti officials as the head of the central bank.

Mr. Abu Su'ud has a degree of financial power that would make even J. P. Morgan blink. Together with the Kuwaiti minister of finance, he is the overseer of more than $30 billion in long-term investments from Kuwait's exports of oil and natural gas. In addition, he must plan the investment of this year's revenues of about $[illegible] billion and supervise the huge personal assets of members of the royal family. "I'm losing my hair worrying about all that money," he says quite seriously.

Having the Emir's Ear

Mr. Abu Su'ud is a portly man whose business suits always look rumpled and whose delight is large Havana cigars. He dismisses suggestions that his position also gives him political influence in such areas as setting oil prices. "I'm a technician, not a politician," he insists. But a Western diplomat in Kuwait suggests that Mr. Abu Su'ud has substantial political influence because "he has the ear of the Emir."

Indeed, it would be impossible not to have a feeling of power, because Western bankers and businessmen who come trying to make a deal in Kuwait "treat him like a god," says the diplomat. Says David Sambar, a London-based investment adviser to Kuwait, "Khaled is the toughest man to see in the Middle East."

He is intimately involved in virtually every important financial decision made in Kuwait, which is the fourth-biggest oil and natural-gas exporter among the 13 members of the Organization of Petroleum Exporting Countries. Only Saudi Arabia, Iran and Iraq gross more.

Kuwait: "10 Years Ahead"

But Kuwait is far ahead of the other OPEC members in its investment techniques. "Nobody can hold a candle to the Kuwaitis in their sophisticated approach to investment," says A. J. Moses, vice president and managing director of Middle East and African advisory services for Chase Manhattan Bank. And Alfred M. Vinton Jr., general manager of Saudi International Bank, adds, "The Kuwaitis are 10 years ahead of other Arab countries."

What the Kuwaitis do so differently is to give emphasis to equity investments, such as the purchase in 1977 of 25.3% of the stock of Daimler-Benz AG, the West German auto maker. Their overall strategy is one of diversification, with investments in everything from real estate to Eurodollar bonds and Middle East development projects.

"Kuwaitis were traders long before they had oil. It's only natural for us to invest broadly," says Mr. Abu Su'ud.

What's more, Kuwait keeps the bulk of its revenues in U.S. dollars rather than switch to West German marks, Swiss francs or Japanese yen. "The American economy is strong. Your country has plentiful natural resources. Your financial markets offer great flexibility," says Mr. Abu Su'ud.

In recent days the astuteness of Mr. Abu Su'ud's investment policy has been borne out. The dollar has at long last showed signs of strength, both in anticipation of and in reaction to the Federal Reserve Board's tough monetary action. At the same time, gold has begun to descend from its record levels of recent weeks. Now Mr. Abu Su'ud must wait to see if the dollar will remain firm or if the reaction is merely fleeting.

A Traditional Haven

It's thought that more private Middle Eastern money than usual had been going into gold in recent weeks. Gold is a traditional haven for Arabs, but all investments by Saudi Arabia, the leading Arab oil producer, are equally conservative. Saudi Arabia puts its money only in fixed-income investments like U.S. Treasury notes, Eurodollar bonds and loans to governments or to blue-chip companies.

"The Saudis don't want any publicity. They feel it only builds up resentment in

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36 THE WALL STREET JOURNAL, Tuesday, Oct. 9, 1979

Power Broker: Kuwait's Money Man Favors U.S. in Placing Oil Billions

Continued From First Page

Western countries," says Khaled M. Al-Fayez, general manager of Gulf International Bank and a former senior credit officer with the Saudi Industrial Development Fund, a government agency. He dismisses some of the Kuwait investments as "flashy headlines."

But change is clearly in the offing. More and more Middle East countries are adopting Kuwait's diversified investment management. As just one example, Mr. Abu Su'ud is helping the United Arab Emirates develop a Kuwaiti-style investment program. One piece of advice he gives: Don't buy gold. "I don't care what the price is today, gold is still a bad investment. Gold has never been a good long-term investment. Its strength is based on a lack of confidence in our economic system," he says.

One powerful reason for this stern opposition to gold speculation is that Kuwait's entire investment strategy is based on the long-term health of the Western economies. Thus, it is adamantly against any speculation that will hurt those investments. Although Kuwait has abundant reserves of oil and natural gas, the royal family realizes only too well that some time in the next century, Kuwait's oil and natural-gas supplies will be seriously depleted. The country then will have to live indefinitely off the investments the government is making today.

That's why Mr. Abu Su'ud believes so strongly that "the dollar is the best currency you can invest in." By comparison, he is pessimistic about the West German and Japanese economies, usually considered so healthy by investors. "What have they got except their brains?" he asks. He believes that ultimately shortages of raw materials and energy will make these countries uncompetitive.

Future Investments

Mr. Abu Su'ud says that about $20 billion, roughly 65% of Kuwait's long-term investments, is in the U.S. The balance is mainly invested in Western Europe, with some also in development projects in the Middle East. Roughly $5 billion, also about 65%, of the country's currency holdings is in U.S. dollars. Kuwait, he says, has anywhere from $1 million to $50 million in stock in almost every one of the top 500 U.S. industrial companies. In addition, there are extensive U.S. real-estate holdings, including part of an office complex in downtown Houston and resort property along the South Carolina coast.

But Mr. Abu Su'ud's major problems aren't so much current investments as what to invest in in the future. The country is taking in so much money for its oil and natural gas that finding suitable and diversified investments is increasingly difficult.

In his search for new investment opportunities, Mr. Abu Su'ud has commissioned a Chicago bank, which he won't name, to make a study that may lead to purchases of large tracts of U.S. farmland. He also expects Kuwait to take a sizable position in the London commodities market before long and to start investing in developing countries such as Brazil and South Korea. For example, it is discussing with South Korea the possible takeover of a 25% interest currently held by Gulf Oil Corp. in a 280,000 barrel-a-day oil refinery south of Seoul.

To advise him, he employs an army of outside financial experts, but despite the billions of dollars involved, he still can act purely on instinct, like many other canny investors. "Sometimes you can't explain why you make a certain deal—you just smell it," he says.

In the same way, Mr. Abu Su'ud rejects instinctively to the world's top money men who visit him. Former U.S. Treasury Secretary W. Michael Blumenthal "wasn't much," he says. He visited Kuwait just once and lectured rather than talked, says Mr. Abu Su'ud. But the new secretary, G. William Miller, "we like," he says. Perhaps he would be even more respected if he did what former Secretary William Simon did: visit Kuwait and have long chats over tea. "Simon was great. He was very open with us and made us feel like we knew where the U.S. stood on every financial matter," says Mr. Abu Su'ud, smiling at the memory.

A Victim of Jealousy

This former teacher has come a remarkably long way since he came to Kuwait from Palestine 25 years ago to teach business administration. He worked his way up to finance minister, only suddenly to face obscurity when he was accused by the now-suspended Kuwaiti parliament of being, among other things, too pro-Western. His colleagues say that he was the victim of other economic officials' jealousy.

But all that changed in 1977 when the then Emir had a fatal heart attack and was succeeded by his brother, the present ruler of Kuwait: Sheik Jaber Al-Ahmed Al-Sabah, the present Emir, had worked alongside Mr. Abu Su'ud in the finance ministry for more than 20 years, and one of his first actions as ruler was to bring his friend in as his personal financial adviser.

Although Mr. Abu Su'ud's position now seems secure, he continues to put in a grueling week. Because the Islamic weekend falls on Thursday and Friday, when the rest of the financial world is functioning, he often must put in a seven-day workweek.

He's on the road about a third of the year, most often in Europe. Even during his brief moments of relaxation, he may get an urgent message that the Emir needs to see

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Enclosure A

Middle East Economic Survey

A weekly review of news and views on Middle East Oil

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'ATIQI OUTLINES KUWAIT'S FOUR-DIMENSIONAL INVESTMENT STRATEGY

The Kuwaiti Finance Minister, Mr. 'Abd al-Rahman al-'Atiqi, has revealed that the return on Kuwait's investments in Europe is running as high as 15 percent, if capital appreciation is taken into account. Mr. 'Atiqi's remarks were made in the course of a press conference in Kuwait on 7 February in which he gave a comprehensive survey of the possibilities facing Kuwait in utilizing its surplus oil revenues. Among the points made by the Minister in this regard were the following:

- Investments in Arab countries represent "captive" money that cannot easily be liquidated, and inter-Arab projects and companies face major obstacles. "It will be a long time before the Arab world arrives at a balanced mutual understanding and finds a basis for active economic cooperation."

- Kuwait is anxious to establish investment relations with the developing countries but is encountering difficulties due to "administrative, technical and other drawbacks."

- As regards domestic investments, Mr. 'Atiqi firmly rejected any projects which do not show a commercial profit as "window dressing." Kuwait should not try to establish heavy industries but should concentrate on medium and light economic projects which are capital-intensive.

Following his initial statement to the press, Mr. 'Atiqi answered questions and revealed amongst other things that the government is planning to auction state land in order to combat inflation and solve the housing problem.

The following is the text of Mr. 'Atiqi's statement and the relevant questions and answers (MEES translation):

"Before 1967 Kuwait did not have large financial reserves and its budget was based on spending 75 percent of its revenues on internal development and allocating 25 percent to reserves and investment. After 1967 Kuwait lived through four lean years because of insufficient revenues. However, after the price of oil was adjusted the situation changed and we began to invest a large part of our revenues - perhaps 75 percent - abroad, while 25 percent was spent internally.

"The period in which there will be large surplus revenues will not last long, since oil is a wasting resource and since the developed countries can strengthen their position and cohesiveness, in contrast to the underdevelopment and fragmentation which prevail in the developing countries.

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F N BAWARSHI
(RESPONSIBLE DIRECTOR FUAD W ITAYIM)

"At the same time we cannot absorb or use the money we have with the required speed and are faced with the problem of what to do with this money. There are international commitments to the IMF and the World Bank, Arab obligations, and obligations towards the Third World and the developing countries in general. All this imposes obligations on Kuwait and the other oil countries far in excess of what was anticipated previously.

"In view of these obligations, we channel our money for investment within four dimensions. On the international level, our policy is based on cooperation with all countries. We try to set up open relations with all countries, within the framework of sound commercial and economic practice. As regards cooperation with the developing countries, we are establishing investment relations with those countries with the aim of developing their economic capabilities without exploitation, but here there are difficulties which relate to those countries themselves, which suffer from administrative, technical and other drawbacks. The third area concerns Kuwait's relations with the Arab states, to which we are linked by blood. And the fourth sphere is domestic investment.

"In considering investments we have to seek investments which give a good return and enable us to keep a large measure of cash liquidity, and this is only available in the European countries and especially in the dollar and sterling markets. We invest a large part of our surplus in the sterling market and then in the dollar market, to a lesser extent in Switzerland and France, and to a slightly greater extent in the West German market.

"We distribute our investments there between financial and real estate portfolios. Similarly, we do not put our funds in one market but try to maintain a large balance in investment, whether in financial papers, deposits, bonds or real estate. These investments have given us a very good return. The return is as much as 15 percent if we count the capital appreciation as well as returns, and 9 percent if we count only the cash returns.

"Our investments in the European countries are distinguished by the fact that they are not subject to direct or indirect taxes, whether in Britain, France or the US, and that they can be liquidated whenever we wish.

"As for the Arab field, I would like to ask first whether we can transfer the bulk of our investments to the Arab world. One cannot have everything one wants. We in Kuwait play a major role, both in providing loans and aid and in trying to stimulate investment. We have been active in the Economic Unity Council, and a number of companies have been set up, as have other companies under the aegis of OAPEC. But with the greatest regret I am not very optimistic about these companies. They face big obstacles, and it will be a long time before the Arab world arrives at a balanced mutual understanding and finds a basis for active economic cooperation.

"People ask why we do not invest our funds in real estate as we do in the West. But there are obstacles to investment in real estate in the Arab world. They ask why we do not invest in Arab shares, but there are also many obstacles in this field.

"I know that the money we invest in the Arab countries cannot be liquidated as quickly as in the European countries. It is captive money, but despite that we accept that our money should be captive since we have a national and communal role to play. All we want are secure conditions which will help development and real investment.

"The third area is the Third World. We have given a great deal to the Third World directly and indirectly.

"Finally we come to the fourth sphere, which is domestic investment. We in Kuwait cannot, for example, spend a large and growing part of our surplus on implementing projects, because that will lead to inflation on the one hand and to a weakening of the purchasing power of the dinar. Despite this, there are many projects which require expenditure and investments.

"People ask why we do not carry out the projects proposed, and why we do not try to develop industry. But I say that any venture or economic project that does not yield a real commercial profit is not an economic project but only window-dressing. And sadly, in our country there are many projects which are uneconomic and superficial at the same time.

"In Kuwait we cannot set up heavy industry because it requires awesome investment, a large work force, and infrastructure and services. We should prefer medium and light economic projects which are capital intensive, technologically advanced and require fewer workers, in addition to maritime transport projects in order not to get bogged down in problems of infrastructure and housing as well as the problems of pollution, increased expenditures on services and others.

"Capital-intensive and labor-saving projects are essential in Kuwait because the state makes large expenditures on education, medicine and public utilities without the citizen or visitor sharing in any way in public expenses through taxes or fees as is the case in other countries."

Mr. 'Atiqi then answered a number of questions from the press.

Q: What role have Kuwait and the Arab organizations played in coordinating Arab economic activities?

A: Kuwait has made great efforts for coordination between the Arab countries in order to lessen the element of window-dressing in economic activities. Some of these attempts have been successful after much effort. Take for example the project for an Arab shipping company. Preparations and consultations for this company took four whole years, during which we warned of the consequences of each Gulf state building its own fleet. This would have led us to ruinous competition. The attempt succeeded. Every project requires a similar effort from us, and I believe OAPEC has succeeded in preventing the Arab oil countries from competing by establishing the oil tanker transport company.

Q: Is it necessary to politicize loans, that is to examine the recipient country's political position on Arab national issues before granting loans? For example how should one deal with India which is not an entirely friendly country, since it has some relations with Israel?

A: Every loan granted by the Kuwait development fund (i.e. KFAED) must be divorced from politics. That is the Fund's philosophy. Political attitudes only play a role when the Arab states as a whole agree that a country is hostile. In such a case we cannot imagine that the Fund would grant a loan to such a country. As for India, we cannot ignore its many stands favorable to Arab issues and the Palestinian cause, nor can we ignore its international weight. Nor can we ignore that despite some relations with Israel it has powerful and historic ties with our area.

Q: What about inflation in Kuwait, despite the Minister's cautionary statements? Why is there no program for the projects which are being carried out? And what effect do loans and aid have on the economic structure of the recipient countries?

A: Inflation in Kuwait is not because of government expenditures but because we are a country that imports most of our necessities and luxury goods and therefore we import inflation. As for the programming of projects, we have not yet attained self-sufficiency in services and other fields, so how can we draw up priorities when we still need schools, hospitals, roads, etc.? We will need priorities when we achieve self-sufficiency.

As for the effect of loans and aid, we only give sizeable loans, aid and grants to the confrontation states, and in particular Jordan, Egypt and Syria. I would have preferred instead of paying cash to these countries to cover their shortfall in resources, to underwrite the costs of well-defined projects whose results and economic returns are known. Nonetheless, what Kuwait and others have given to these countries is very little in comparison with the sacrifices they have made.

Q: There are reports that it is the oil countries which are placing obstacles in the path of setting up joint Arab companies and of developing investments in the Arab world.

A: Every project proposed by the Economic Unity Council was first proposed by Kuwait which has participated vigorously and by various methods in bringing them to the stage of practical implementation.

Mr. 'Atiqi also revealed that as part of the government's anti-inflation measures it intends to auction off state-owned lands:

"The government intends shortly to offer government land for sale, and this will be announced next week. The land in question is within the city and in the 'Aridiya and Fantas areas and elsewhere. Fifty percent of the price will be payable at the time of its purchase by auction, and the remainder within one month from the date of registration. Plans for building on the land must be drawn up within six months, so that building can start within a year from the date of purchase. The owner will lose title to any land that is not built on within three years, and ownership of the land cannot be transferred until building has started. This should solve a large part of the housing problem."

IRAN

1. Hoveida Says Iran's Foreign Purchases Depend on Oil Sales: The Iranian Prime Minister, Mr. Amir Abbas Hoveida, has warned that unless the Consortium companies increase their liftings of Iranian crude, Iran will revise its relationship with the Consortium and cut back on all its purchases abroad. "If you want to sell us more, you'd better buy more oil. After all it is trade and balance of payments. You can't correct your balance of payments and put mine in the red," Mr. Hoveida said in an interview with the Washington Post published on 9 February.

Mr. Hoveida alleged that the shortfall in Consortium liftings - estimated at some 740,000 b/d in 1975 - was an attempt to force Iran to reduce its prices, and said that "if the Consortium companies are trying to get us to lower our price by getting the other producers against us, they are going to be the fool of the game." He added that the National Iranian Oil Company (NIOC) was fully capable of handling the sale of all Iran's oil exports. "Either the Consortium has to stick to the agreement or we should have a new agreement, and if the Consortium is not in a position to sell our oil we can sell it."

Referring to the $2.1 billion deficit in the 1976-77 budget announced on 3 February, Mr. Hoveida insisted that the foreign oil companies and not government overspending were to blame. "We overspent with open eyes. We took the occasion of more income at one time to make a jump, and I do not shed any tears about our couple of miserable billion of dollars deficit."

Mr. Hoveida's comments came after a new round of negotiations with the Consortium which began in Teheran on 27 January. Among the subjects discussed was the outstanding issue of the Consortium's failure to pay its 40 percent share of capital investment for exploration and production in Iran (MEES, 23 and 30 January). According to reports, Consortium officials reached agreement with the Shah of Iran before the negotiations opened that the Consortium's payments should be postponed for a month or two, and that NIOC would take over the payments until negotiations are completed. The companies say that they cannot continue putting up their 40 percent share of investment - estimated at over $500 million for 1976 - so long as margins remain insufficient. These, they claim, are now only 10 to 15 cents/barrel instead of the anticipated 22 cents/barrel.

With investment in production and secondary recovery operations for the Iranian oilfields projected at $1-2 billion annually over the coming years (some $17.5 billion between now and 1985), Iran's oil is moving into a distinctly higher cost bracket than hitherto; and the companies - both in Iran and elsewhere in the area, such as Saudi Arabia and Abu Dhabi - are looking for stable new arrangements which will guarantee them a certain return on investment or, where no investment is required, a suitable fee for services rendered. One solution to the Iranian problem would be for the companies to bow out of the investment requirement and pay market prices for crude, with a fee for any services - rather as is being contemplated in Saudi Arabia.

As far as crude oil output is concerned, Iran's potential is, of course, nowhere near that of Saudi Arabia (though Iran's gas potential - see Supplement to MEES, 7 February 1975 - is extremely high), and the capacity of some of the Iranian fields has proved to be less than originally anticipated. According to some major oil company estimates, Iran's oil export potential from the Consortium area - now over 6 million b/d - is likely to slip to something like 3 to 3.5 million b/d by the early 1980's as a result of (a) natural decline in the fields, and (b) the rapid increase in local consumption, which is now running at 350,000 b/d and could reach 1 million b/d or more in the early 1980's.

(e) Implementing the recommendations of the engineering studies with regard to the "A" and Ratawi limestone reservoirs of the Khafji field, and following up on the behavioral changes in the first and second Bahrain reservoirs of the same field.

(f) Studying the development of Dorra field and the possibility of developing the Lulu field. Also carrying out an engineering study of the "A" limestone reservoir of the Hout field.

(g) Completing the studies on the Eocene formations of the Wafra field in cooperation with Saudi Arabia.

(6) The program for crude oil production includes:

(a) Introducing certain changes in the gas separators of the crude oil gathering centers in southeast Kuwait.

(b) Constructing desalting units for crude oil produced from the offshore areas of the Partitioned Neutral Zone.

(7) The program for the processing of crude oil includes the following projects:

(a) A hydrocatalytic cracker in the Shuaiba refinery to improve the quality of refined products.

(b) A lubricating oils blending plant to meet local requirements.

(c) A lubricating oils plant.

(d) The modernization of the Mina al-Ahmadi refinery.

(e) A bitumen plant to meet increased local consumption.

(f) The modernization of existing refineries through the construction of elevated, instead of ground-based, furnaces and a new oil separation unit for the al-Ahmadi refinery.

(8) To utilize the natural gas output of KOC's oilfields through the production of LPG. Also to prepare the necessary studies on the acquisition of an LPG tanker fleet and the establishment of the necessary operating authority.

(9) The program for the production of petrochemicals and fertilizers includes the following projects:

(a) An ethylene and plastics complex.

(b) A plant for the production of aromatic hydrocarbons.

(c) A fourth ammonia production train for the Shuaiba fertilizer plant.

(d) Improvement of existing plants with a view to increasing their capacities.

(10) The program for transportation and storage includes the following projects:

(a) Improving the efficiency of transportation lines.

KUWAIT OIL MINISTRY DRAWS UP THREE-YEAR OPERATIONS PROGRAM

(Kuwait's Ministry of Oil has drawn up a program detailing its projected operations over the coming three years, as part of an overall three-year governmental program covering all the ministries in Kuwait. This overall program has been submitted to the National Assembly for approval. The following is a MEES translation of a draft of the Oil Ministry's program, as published in the Kuwait daily al-Siyasah on 2 February.)

(1) To establish a Council for the Conservation of Petroleum Resources that will implement the Oil Conservation Law (No. 19 of 1973) and its regulations (A Ministerial Decision was issued on 1 January setting up the Council - MEES, 9 January).

(2) To issue a handbook on inspection in the petroleum industry that will incorporate technical methods and procedures to be followed in this field.

(3) To draw up a program for exploration and prospecting that will include:

(a) Carrying out seismic surveys of (a) the offshore 6-mile territorial waters contiguous to the shores of the Partitioned Neutral Zone together with another survey comprising 900 kms. of seismic lines in the same area, and (b) the Burgan and Dibdiba/Ladira South areas in Kuwait, to determine suitable locations for drilling.

(b) Drilling an exploratory well in the Burgan field to probe the underlying deep geological formations (for a detailed report on the deep test well, see MEES, 6 February), and other exploratory wells in (a) the Dibdiba/Ladira West area of Kuwait, and (b) Wafra, North Fuwaris, al-Ahmadi elevation, 'Arq and Misha'an (onshore) and the Dorra and Khafji field (offshore) in the Partitioned Neutral Zone.

(c) Carrying out comprehensive geological and geophysical studies of West Kuwait and the offshore Partitioned Neutral Zone areas.

(4) To draw up a program for development drilling and the workover of wells that will include:

(a) Drilling 13 development wells in the Hout and Khafji fields and 42 wells in oilfields in Kuwait and the Partitioned Neutral Zone (onshore) and continental shelf.

(b) The workover of 185 producing wells in the areas mentioned above.

(5) To carry out reservoir studies that will include:

(a) Carrying out a study of the Wara sandstone (Middle Cretaceous) reservoir of the Burgan field and the Mauddud sandstone reservoir of the Sabriyah field.

(b) Following up on the study of the problem of water seepages in the third and fourth sandstone formations of the Greater Burgan field.

(c) Evaluating and following up on the gas injection scheme of the Middle Zubair reservoir of the Raudhatain field.

(d) Evaluating the probable reserves of all discovered fields and reevaluating the reserves in place of all other producing reservoirs in the light of up-to-date information.

(b) Two alternative projects for either increasing crude oil storage capacity or the efficiency of the loading facilities at Mina al-Ahmadi.

(11) The program for marketing crude oil, petroleum products and gas includes:

(a) Drawing up an effective marketing program which takes into account the realities and conditions of the international crude oil markets and setting up marketing offices in the major centers of the importing countries.

(b) Developing local expertise in the crude oil and gas marketing business by sending some of the Ministry's employees for training abroad in marketing operations, and importing know-how and expertise to assist in training and marketing operations.

(c) Establishing a department for petroleum research and marketing to study international crude oil markets and to follow up on developments in these markets.

(d) Reevaluating previous marketing and economic studies and updating them in the light of changed conditions in the international crude oil markets.

(e) Establishing a specialized petroleum affairs information center comprising a scientific library containing up-to-date reference material, specialized periodicals, microfilming units and electronic computers.

(12) Developing the work force and organizational cadres of the petroleum sector and the training of workers.

(13) Completing the building of the residential area at Nuwaisib in the Partitioned Neutral Zone in cooperation with the Kuwait Municipality and the Arabian Oil Company (Japan).

(14) Developing al-Ahmadi town, in cooperation with the Kuwait Municipality and the Ministry of Housing, to accommodate petroleum sector workers.

(15) Studying international crude oil and products markets and cooperating in this field with the other Gulf states.

(16) Drawing up a strategy for the export of crude oil.

APPENDIX 3.—MATERIAL ON MIDDLE EAST OPEC GOVERNMENT DEMANDS FOR PREFERENTIAL TREATMENT OF INVESTMENTS AND U.S. GOVERNMENT RESPONSES THERETO

A. DEMANDS FOR SPECIAL TREATMENT BY A MIDDLE EAST OPEC COUNTRY, MADE BEFORE THE CIEC IN 1976 AND RESPONSES THERETO

CONFERENCE SUR	CONFERENCE ON	CONFERENCIA SOBRE	مؤتمر
LA COOPÉRATION	INTERNATIONAL	LA COOPERACION	التعاون
ÉCONOMIQUE	ECONOMIC	ECONOMICA	الأقتصادي
INTERNATIONALE	CO-OPERATION	INTERNACIONAL	الدولي

COMMISSION: FINANCIAL AFFAIRS

26, APRIL 1976

SUBMITTED BY: SAUDI ARABIA
ON BEHALF OF GROUP OF 19

SUBJECT: FACILITIES AND SAFEGUARDS REQUIRED FOR INVESTMENT OF SURPLUS RESERVES OF OIL EXPORTING COUNTRIES.

CONFERNECE ON INTERNATIONAL
ECONOMIC COOPERATION

COMMISSION ON FINANCIAL AFFAIRS

FACILITIES AND SAFEGUARDS REQUIRED FOR INVESTMENT OF SURPLUS RESERVES OF OIL EXPORTING COUNTRIES

Presented by:

Saudi Arabia

on behalf of Group of 19

26 April 197

1. Surplus reserves of the Governments of oil exporting countries for which investment outlets have been sought in developed countries have been acquired not so much by choice as by moral obligation, to meet the energy requirement of the world community, principally the developed countries themselves. Having parted with their depleting resource, hitherto lying secure in their ground, in quantities disproportionate to their immediate need for earnings, measures should be considered regarding the special case of the financial assets of the oil exporting countries, without prejudice to the traditional positions taken by developing countries at international forums particularly the Declaration and Program of Action adopted by the VI Special General Assembly of the United Nations and the Charter of Economic Rights and Duties of States, and their national policies and legislations with regard to foreign investment.

2. Generally these assets consist of:

a) Demand and Time Deposits with banks, CDs, Bankers Acceptances and other bank obligations.

b) Debt instruments of Governments, Government Agencies and Public Corporations.

c) Debt instruments of companies and corporations in in the non-financial private sector.

d) Common stock and other equity investment.

e) Real Estates.

3. The risks and problems related to these assets are:

a) Erosion of capital as a result of inflation.

b) Capital loss accruing from external depreciation of currencies in the prevailing regime of floating rates.

c) Restrictions on movement of capital imposed by national authorities.

d) Taxation.

e) Political risks and coercive measures.

4. The sharp rise in export prices of industrial countries having already taken a heavy toll of the earnings of developing countries through increasingly inflated cost of their mounting imports from these sources, the diminishing value of oil exporting countries' financial assets as a result of inflation in developed countries has compounded their loss and vividly brought home to them the disadvantages of increasing oil production in exchange for financial assets in developed countries. To sustain the momentum of production in countries that are presently not in need of the corresponding level of earnings, they expect that official financial assets be protected from erosion due to inflation through suitable policies and arrangements.

5. Major oil exporting countries have always avoided speculative movement of capital and taken care not to cause by their investment operations any embarrassment to the relevant monetary authorities, they cannot but be deeply concerned at the prospect of their assets losing value through continuing or frequent depreciation of currencies. With the advent of floating exchange rates there is discernible a greater permissiveness in monetary management and a reluctance on the part of certain authorities to maintain the external value of their currencies and take appropriate measures to check its sharp fluctuations. Oil exporting countries cannot for long remain indifferent to these developments and go on incurring losses on investment of their public funds as a result of continuing currency fluctuation. They expect the external value of their investments be protected by host governments of developed countries against their currencies depreciation.

6. While recognising the right of national authorities to regulate foreign investment and insulate their economies from spectulative short-term movements of capital, it needs to be emphasized that oil exporting countries are interested only in portfolio investment which is not of speculative character and should receive a different treatment. They expect as free an access to investment opportunities in developed countries as the access they offer them to their oil.

To safeguard their interest the Governments of oil exporting countries seek opportunities for diversification in terms of countries, currencies, institutions and instruments and wish to invest in as many of the developed countries as are in a position to offer suitable facilities and prospects. They are however frequently confronted particularly in the case of countries with stronger currencies, with barriers put up by national authorities to check capital inflows. Non-payment of interest to non-residents on bank deposits, their ineligibility for holding certain popular debt instruments, strict regulation and rationing of foreign bond issues, official permission required for purchase and sale of domestic debt instruments, are some of the difficulties confronting oil exporting countries seeking genuine opportunities of investment in those markets.

7. While income of foreign governments from investments is in certain developed countries exempt from tax either by statute or through special dispensation, in some other developed countries, important from investment point of view, withholding tax is payable by government entities and central banks like any other non-resident on income from almost all investments. Even in a major country where exemption from income tax is conferred by the income tax law, it is applied only to what is called passive income. Tax on income derived from investment of public funds is obviously a great disincentive for the investment of those funds. Therefore, it is expected that the official financial assets of oil exporting countries should be given preferential treatment with respect to taxes on income and capital gains.

8. Any discussion of the protection or safeguard required for oil exporting countries' official investments in developed countries must start with a clear perception of the circumstances in which these investments have been and are being acquired.

Because of the rapid depletion of the natural resources of the oil exporting countries in order to satisfy the energy requirement of the developed countries they have accumulated a temporary financial surplus beyond their internal absorbtive capacity, the following effective steps should be taken by the developed countries to safeguard the investments of oil exporting developing countries in their markets against:

- confiscation, freezing and any other coercive measures to deprive these countries of their investments and income therefrom. In case of expropriation and nationalization, developed countries should guarantee an appropriate compensation.

- Unwarranted restrictions on prompt conversion and transfer of investment and income therefrom from host country's currency into freely convertible currencies at agreed rates.

9. It is considered that any claim of a state to extend jurisdiction to assets held with its subjects bank offices and branches in third countries as contrary to international customary practices are unjustified. Therefore, it should be recognized that banks established in foreign countries are fully subject and protected by the laws of the host country.

10. Oil exporting countries are fully conscious of national interests regarding prospect of control of key industries or strategic sectors passing into foreign hands. They at the same time expect that they will get at least the same access to investment opportunities as other foreign investors have.

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TREASURY DEPARTMENT

Document B-4

SUMMARY OF MEMORANDUM

Date: April 1976

To: A Treasury Official

From: A Treasury Official

Subject: CIEC Discussion with a Middle East OPEC Country

Attached, as requested by a high level Treasury official, is a revised set of his talking points and background on the FAC for the discussion of that official with a high level official of a Middle East OPEC country this week. Recent events at the FAC meeting in Paris are reflected in the revision.

Attachment

Middle East OPEC Country Position in the CIEC Financial Affairs Commission

Issues: In the first two meetings of the CIEC Financial Affairs Commission (FAC), the Middle East OPEC country's delegate has indicated that they will push strongly for special treatment of OPEC financial assets in the industrialized countries -- in terms of protection against inflation, exchange risks, risks of expropriation and blockages of funds. He threatened that his country might cut back oil production if their assets were not accorded the desired treatment.

In the third meeting of FAC ending Wednesday of this week, the emphasis has been on requests for guarantees for "appropriate compensation" in case of expropriation and for "freely convertible currencies at agreed rates." The indexation of financial assets was not used in the G-19 paper (which is attached) submitted in the April FAC meeting the the Middle East OPEC country. U.S. tax treatment of investments of the Middle East OPEC country is also of concern.

Talking Points

1. As you know, the U.S. has steadily exhibited concern over the safety of international investments, the belief is that investment should be free to flow across national borders. We have provided a safe milieu within the U.S. for foreign investment.

   Your delegation has argued that there is a need to provide special measures to protect the financial assets of the OPEC countries. I have seen the G-19 paper submitted to the FAC this week, and I am interested in hearing your detailed views on this subject.

2. What is your view more generally on the discussion that has taken place thus far in the CIEC Financial Affairs Commission?

3. How do you think the FAC discussion will evolve this year?

Background

Financial Safeguards: In the February and March sessions of the FAC, the Middle East OPEC country was represented by certain officials. (For a brief period in the March session another official set in the chair of the Middle East OPEC country but did not participate in the discussion.) An official of the Middle East OPEC country has repeatedly stated that the Middle East OPEC country is seeking new measures to protect its financial assets from inflation, exchange rate risk and expropriation and blockage of assets. He argued that if such protection is not forthcoming the Middle East OPEC country might well follow another approach to solving the "problem" of their surpluses, namely reducing oil production to levels just necessary to generate their current foreign exchange needs. The officials of the Middle East OPEC country have spelled out their demands in the current April session after having difficulty getting their paper thru the G-19 caucus.

We have conflicting reports of just how serious the Middle East OPEC country is in seeking the indexation of OPEC financial assets and guarantees against seizure of blockage. The Middle East OPEC country did demand the creation of the Financial Affairs Commission, and its delegate has stressed these issues strongly even though it is a devisive issue in the G-19. It could well be a tactical ploy. We have heard that the officials of the Middle East OPEC country really do not expect agreement on financial asset indexation and they surely recognize there are limits to which we could assure that their assets would not be blocked. Also, the officials of the Middle East OPEC country have not sought bilaterally to have the US provide indexed securities nor to our knowledge have they complained about the arrangements now in effect for their investments in USG securities. The bilateral approach would seem more likely if the officials of the Middle East OPEC country were serious.

Monetary Issues: In the first session of the FAC, the officials of the Middle East OPEC country were most insistent on including "monetary issues" in the work plan. Their delegate did not seem to recognize the dangers of having the FAC discuss issues that are clearly the responsibility of the IMF and the IBRD, arguing several times, for example, that the Kingston meetings did not result in "needed changes in the decision processes" in these institutions. Evidence from the April meeting implies that this thrust has been blunted.

Taxes: Dividends and interest received by the Government of the Middle East OPEC country, including wholly owned instrumentalities making passive investments in the U.S. and meeting certain governmental criteria, are exempt from the 30% U.S. withholding tax on the dividends and interest. Capital gains taxes do not apply to a non-resident foreign investor. The proposed tax treaty with the Middle East OPEC country, that is consistent with other U.S. treaties, would permit exemption from U.S. tax on interest for any resident of the Middle East OPEC country, and dividend withholding rates would be lowered from 30% to 5% in the case of ownership of 10% or more of the stock of a U.S. company and to 15% if less than 10% is owned. These rates would apply where the investor was not considered a government and rulings would not be required to obtain the lower rates. The capital gains exemption rule would be confirmed in the proposed treaty.

Treasury has proposed removal of withholding on dividends and interest by legislaton. It appears unlikely that this Congress will act favorably on this proposal.

General: It would be useful to obtain views of the official of the Middle East OPEC country on discussions in the Financial Affairs Commission and to ascertain whether he fully shares the positions and approach taken so far by the Middle East OPEC country. Our reason for questioning this is that the Middle East OPEC country delegate has been outspoken in his support for a new international economic order and his statements charging the industrialized countries with "exploitation" of the LDC's, to the apparent embarrassment of others in his delegation and others in the G-19. At times, even the delegate from another Middle East OPEC country came across as more moderate.

CONFERENCE SUR LA COOPERATION ECONOMIQUE INTERNATIONALE

CONFERENCE ON INTERNATIONAL ECONOMIC CO-OPERATION

CONFERENCIA SOBRE LA COOPERACION ECONOMICA INTERNACIONAL

مؤتمر التعاون الأقتصادي الدولي

COMMISSION: FINANCIAL AFFAIRS

June 10, 1976

SUBMITTED BY: UNITED STATES DELEGATION

SUBJECT: Further U.S. Comments on G-19 paper on Oil Exporting country International Investments : The Issues of Exchange Rate Risk and Political Risk

FURTHER U.S. COMMENTS ON G-19 PAPER ON OIL EXPORTING COUNTRY INTERNATIONAL INVESTMENTS: THE ISSUES OF EXCHANGE RATE RISK AND POLITICAL RISK

Mr. Chairman:

You will recall at our last meeting the United States delegation made some statements which responded to various elements in the paper on safeguards for investment which was presented by the representative of Saudi Arabia on behalf of the G-19. We described the U.S. "open door" policy to foreign investment and the "national treatment" which foreign investors receive, including legal safeguards. We discussed the nature of oil exporting countries' external assets. We also addressed the purchasing power of these external assets, noting that artifical schemes to protect only some creditors, but not all, against the negative effects of inflation would be inherently discriminatory, would be technically complex to construct, would result in severe distortions and might actually complicate the primary task of bringing down inflation rates. The appropriate international approach to the effect of inflation on the real value of investments--which, we agree, is a serious problem for investors--is for all of us to increase our commitment to controlling inflationary pressures in the world economy. There is no substitute for our achieving this.

Exchange Rate Risk

Today, I would like to respond to the two issues of exchange rate risk and political risk as they were raised in the G-19 paper. With respect to the issue of the exchange rate risk as it affects the international investments of the oil exporting countries, the G-19 paper states that:

- -- there is a prospect that oil exporters' assets will lose value "through continuing or frequent depreciation of currencies"; and

-- "they expect the external value of their investments be protected by host governments of developed countries against their currencies' depreciation."

In addition, the G-19 paper purports to detect "greater permissiveness in monetary management" in the wake of the advent of widespread floating.

Taking first this latter assertion, the U.S. would not agree that a system of flexible exchange rates induces less responsible domestic economic policies. The external results of poor domestic policies are much more likely to be perceived by the public under flexible exchange rates--via an increase in the cost of imports--than under "fixed" rates, where the results are reflected initially only in central reserve or borrowing operations.

The record is clear that the recent virulent inflation originated under the par value system and has subsided during a period of floating rates. It must be remembered that true "fixed" rates are not an alternative, and that the Bretton Woods system itself--contrary to what might be inferred by some references to it vis-a-vis floating--did not preclude exchange rate changes. Par value changes at times were associated with crisis conditions, frequently accompanied by the imposition of administrative measures such as exchange controls and investment restrictions which impact adversely on international investors.

It is now generally recognized that exchange rate changes cannot be prevented simply by declaring and defending a fixed value in terms of other currencies, and that such efforts can, indeed, lead to instability. The new monetary arrangements, agreed upon in Jamaica and forming a central part of the amended IMF Articles of Agreement, recognize that the only valid path to international monetary stability is the pursuit of policies which converge toward stability, i.e., <u>not</u> relying on the system in an attempt to force stability from the outside.

With reference to the first concern expressed by the Saudi Arabian Representative (future loss of value through depreciation), we would not deny the possibility that currencies of the countries in which oil exporters invest their surplus assets will fluctuate vis-a-vis one another to some degree in the future--as they have in the past. This means, of course, that the nominal value of investments denominated in depreciating currencies would diminish in comparison with those denominated in appreciating currencies.

Some relevant considerations, however, should be taken into account: (a) Although many oil exporters' foreign assets are held in short-term forms, they represent in fact long-term investments so that the analysis should not focus on short-term and temporary fluctuations. (b) All currencies cannot depreciate together. Thus exchange "losses" on certain investments tend to be compensated by "gains" in others. (c) Generally, some compensation for holding particular currencies, especially somewhat weaker ones, is derived from the higher yield usually available on such currency. (d) Residents of major industrial countries are constantly making portfolio choices based on these considerations.

Turning to the expressed desire for protection by host governments of developed countries against losses entailed by any depreciation of their currencies, I would offer only some general observations.

As I noted above, stability of exchange rates is a generally accepted goal and the U.S. supports this goal firmly. As was agreed by representatives of all IMF members at Jamaica in January and confirmed overwhelmingly by Governors of the Fund, the only way to reach it is to focus not on action to peg or manage exchange rates but on achieving, as a prerequisite, underlying economic stability. We certainly intend to pursue that goal, which in the first instance entails suppressing the inflationary forces which continue to plague us. Mutual success on this front would be the best way of fulfilling the expressed desire of those seeking security for their investable surplus.

While it is understandable that an investor would like to have specific assurances against exchange risk (or any other risk), there is no reason why a host government ought to bear the exchange risk entailed. Historically, international investments have always been subject to exchange risk, and it has been the investor's responsibility to calculate an exchange risk factor into the rate of return he is willing to accept for his investment.

While OPEC may look upon investments obtained from the sale of oil as "special," financial markets cannot and do not distinguish between funds on the basis of their source. Nor does the United States Government. Apart from our view that the market price mechanisms should prevail as the determinant of capital investment flows, granting special treatment to certain classes of investors would contradict the strongly held principle of non-discrimination.

Naturally, both lender and borrower should retain the option of refusing to conclude a transaction on unsatisfactory terms. While protection against exchange rate risk may be an important consideration to lenders, it is only one of the elements in the investment decision. Investors can diversify their investments over a wide range of currencies and types of investment to accomplish their investment objectives. The main point is that investment transactions must be satisfactory to both parties.

Political Risk

Turning to the issue of political risk, the G-19 paper states the concern of oil exporting country investors about the political risks of "confiscation, freezing and any other coercive measures to deprive the OPEC countries of their investments and income therefrom." In the case of expropriation and nationalization, the paper calls for developed countries to guarantee an appropriate compensation.

We acknowledge that these perceived political risks are of concern to the oil exporting country investors and merit our attention. Yet with respect to investments in the United States, we note our statement in April that in our view our Constitution, our policy towards foreign investment and our bilateral treaties provide very substantial protection against such political risks.

Taking a broader view of the problem, the United States has often stated the importance we attach to achieving more favorable environments for international investments world-wide. Actual or perceived political risk is an important aspect of a nation's investment environment. As we have stressed in past meetings of this and other CIEC Commissions, the international flow of capital is an important factor contributing to economic development and progress. It is in the interest of all countries--the oil exporting countries, the non-oil developing countries, and the industrialized countries--that foreign investors be assured of stability and certainty of operating conditions, recourse to appropriate dispute settlement mechanisms, and protection against expropriation contrary to the norms of international law.

We would agree, therefore, that the G-19 paper identifies an important issue, but we think it must be considered in a broader context than just with respect to OPEC investments in developed countries. The issue is more general than this, and, moreover, were we to address just this one aspect of the problem, the likely result would be a distortion of capital flows towards the industrialized countries and away from the developing countries. We believe, therefore, that it is more useful to explore this question on a more global, multilateral basis.

We have found that the best approach to this problem of the political risk facing international investors is through mutual recognition of reciprocal responsibilities and norms of behavior. We have achieved substantial reductions in political risk both through our network of bilateral treaties and through multilateral understandings within the OECD group.

In his statement today, the EC delegate made several important suggestions for reducing the political risks facing international investors which would be responsive to the concerns of the oil exporting country investors and other international investors. We think their suggestions merit our careful consideration. I would like to suggest another possible approach for consideration in the CIEC, a multilateral agreement, perhaps in the form of a convention, with reciprocal obligations for the protection of foreign investments in and by the participating countries. Such an agreement would include the basic protective provisions found in bilateral treaties relating to investment. Such a mutually agreed multilateral approach should include as participants the oil exporting countries, the industrailized countries, and the non-oil developing countries. While it would be responsive to the specific concerns of the oil exporting country investors, such an agreement would also benefit the non-oil developing countries through facilitating the flow of international capital to these countries.

CONFERENCE SUR LA COOPERATION ECONOMIQUE INTERNATIONALE

CONFERENCE ON INTERNATIONAL ECONOMIC CO-OPERATION

CONFERENCIA SOBRE LA COOPERACION ECONOMICA INTERNACIONAL

مؤتمر التعاون الأقتصادي الدولي

COMMISSION: FINANCE

10, june 1976

SUBMITTED BY: EEC

SUBJECT: EXTRACTS FROM THE ADDRESS BY THE EEC SPOKESMAN ON THE SURPLUS ASSETS OF THE OPEC COUNTRIES.

86-722 O - 82 - 27

EUROPEAN COMMUNITIES
C.I.E.C.
Commission on Financial Affairs

Paris, 10 June 1976

Extracts from the address by the EEC spokesman on the surplus assets of the OPEC countries

1. Following our initial statement in response to that of the distinguished delegate for Saudi Arabia at the April session of the 4th Commission of the C.I.E.C., we undertook a more detailed analysis of the document entitled "Facilities and safeguards required for the investment of surplus reserves of oil exporting countries". This reading confirmed the impression we had had of the high quality of his address, and we would like to express to him our appreciation of the high sense of responsibility demonstrated by a country whose financial situation, in common with that of certain of its neighbours, has such special characteristics that nothing like them has been seen in modern economic history.

   The delegate for Saudi Arabia illustrated this sense of realism particularly well when he recognized the problems which might arise as a result of direct external investment in certain sensitive sectors of the industrialized countries, and when he recalled the wise financial investment policy of his country. Several of his proposals are wholly reasonable. Particularly since these are problems the solution of which is of interest to both the industrialized and OPEC countries, we are ready for example to examine in a very favourable light the proposals relating to commitments concerning political risks and to appropriate compensation in the case of nationalization.

2. Although we are in broad agreement with several of the conclusions of the distinguished delegate for Saudi Arabia, we are less so with the reasons adduced in his address in connection with the concept of the special nature of the OPEC surpluses, a concept which is justified by the particular nature of the resources from which they are obtained, and with the requests which derive therefrom

might set a bad example. Requests would then be submitted for the recognition of the specific properties of other categories of products or assets, with the risk of a proliferation of special situations and the abandonment of the multilateral nature of international economic relations.

3. The fact remains that the situation of Saudi Arabia and the OPEC countries in the same position is special by virtue of the extent of their resources and their low capacity for absorption. For this reason the Community considers it necessary to recognize the concern expressed by the representative for Saudi Arabia and to endeavour, as far as possible, to give concrete and positive replies to it, taking into account the extent of the problem of surpluses and the complementarity of the interests involved.

4. The distinguished delegate for Saudi Arabia raised in his document the matter of protection against monetary erosion due to inflation and mentions, with a view to ensuring such protection, appropriate policies and arrangements. It is true that an inflationary situation can exacerbate the risks which invariably attach to the possession of a claim. We believe that the best protection in this connection would be

- a reduction of inflationary tensions, an objective which we all, in the light of our particular national requirements, attempt to achieve through our economic policies, and in the pursuit of which we hope to continue to benefit from the assistance of the OPEC countries,

- and also, adequate administration of assets leading to a distribution giving preference to longer term investments and investments in real property.

For our part, we are ready to encourage a reorientation of this type, since at the present time there are no obstacles of principle to OPEC investments, or any discrimination in regard to this group of countries, and in fact our policy is very liberal in regard to both securities and direct investments (apart from the question of the sensitive and strategic sectors, as the distinguished delegate for Saudi Arabia has himself accepted). We are ready to facilitate the re-direction of OPEC investments by:

- improving the system of reciprocal information concerning rules applying to external investment;
- ensuring that OPEC operations and the relevant bilateral consultations take place with the discretion postulated by the very volume of the operations;
- implementing measures of industrial co-operation with a view to encouraging joint ventures for specific projects, for instance in the energy sector, in which certain OPEC countries have evinced particular interest;
- participating in the promotion of triangular co-operation formulas which provide balanced benefits for the three parties involved. In this connection, it may be recalled that certain previous addresses have highlighted the good profitability of capital invested in the developing countries.

These problems are linked with those of the <u>protection of investments</u>, which we deal with later.

. Let us now deal with the problem of protection against the risk of exchange fluctuations. We think that this can be achieved by spreading investments evenly amongst the currencies. This spread may certainly <u>sometimes</u> be <u>temporarily</u> hindered by restrictive measures (mentioned under points 3c and 6 in the document submitted by Saudi Arabia) which may be adopted in one country or another for reasons of monetary policy. In this connection it should be emphasized once again that such measures are not discriminatory and that they make it possible to limit excessive fluctuations in exchange rates, which benefits everybody concerned, and to realise the importance, in view of the volume of funds involved, of collaboration between the monetary authorities the investment and diversification of their assets.

This protection can also be obtained by recourse to formulas based on the use of composite units of account. It should however be remembered that certain banks proposed deposits and other instruments in such units of account in 1975 and that this move was not successful. This can be explained by the fact that investors who have considerable funds at their disposal can themselves spread their investments over the various currencies.

6. As regards taxation problems, it should be emphasized that precisely because of the principle of non-discrimination which is observed by all the countries of the Community, it is not possible to make special arrangements for certain categories of investors. The delegate for Saudi Arabia has mentioned the obstacle represented by the existence in several countries of deductions at source from interest and dividend payments. But apart from the fact that this is not general, it is doubtful whether this obstacle plays a decisive role in this field; it may be recalled in this connection that certain Community attempts to invest direct in OPEC countries without deductions at source were not received as well as might have been expected.

We would however be ready to consider to what extent the extension of double taxation agreements could help to solve any problems which might arise.

7. In his address, the distinguished delegate for Saudi Arabia mentioned problems of production and of guarantees for OPEC investments. In the first place, no problems are likely to arise in our countries in connection with transfers for foreign investments and the income deriving therefrom. Furthermore, we have no intention of nationalizing any external assets whatsoever without adequate compensation, as past experience readily shows. Be this as it may, the protection of investments and transfers, and guarantees covering the political and nationalization risks are in our opinion a vital objective, not only in relations between the OPEC and industrialized

countries and the developing countries. These two types of relationship cannot be considered entirely independently of one another, if only because the industrialized countries, which re-route part of the OPEC surpluses to the developing countries and thus play an active and valuable part as intermediaries, would be better equipped to improve the quality of this process (inasmuch as long-term investments in the developing countries would take greater priority) and to offer satisfactory security to primary lenders if they were themselves protected against the risks of various kinds to which their investments in the developing countries might be subject.

In regard to the methods to be adopted to achieve the desired result, and speaking generally, we recommend in the first place, with a view to ensuring the promotion and stability, on a reciprocal basis, of our financial relations with both the OPEC countries and developing countries, the extension of bilateral agreements for the protection of investments. These agreements, based on the principle of non-discrimination, should cover in particular tax treatment, the transfer of profits, the liquidation of investments and arbitration in cases of dispute.

On the basis of guiding principles to be established jointly, the standardization and multilateralization of these agreements would be conceivable. If, finally, the questions of nationalization, international arbitration and the allocation of financial burdens were resolved by multilateral agreements involving a sufficient number of industrialized countries, OPEC countries and developing countries, an international system for the insurance and guarantee of international investments could be studied. These proposals have already been submitted by the Community, but no definite reaction from the 19 has been noted, and we believe that a detailed discussion of the problems could be beneficial and that progress in this field would be of value to all parties concerned.

B. MATERIAL ON NEED FOR, OR DESIRABILITY OF, PREFERENTIAL TREATMENT OF OPEC COUNTRY INVESTMENTS

LIMITED OFFICIAL USE

Department of the Treasury
Office of the Assistant Secretary for International Affairs

to: Messrs. Klock and McCown

From: James M. Lister

room: date: 3/18/76

Subject: Briefing Paper on Uniqueness of Saudi Current Surplus

Attached is a copy of the paper taken to Paris by a State rep to substitute for the earlier draft. I tried to work in as many of your comments as was feasible.

cc: Messrs. Griffin and Pritchett

LIMITED OFFICIAL USE

Alleged Uniqueness of Saudi Current Surplus

Suggested Talking Points (substitute version)

1. For every surplus country, including Saudi Arabia, the size of its current account surplus reflects decisions on the size of domestic saving, and its disposition between internal real investment and the net accumulation of external claims.

2. For every country, too, some of what is conventionally called saving -- current income less current consumption -- involves transformation of assets. Conventional GNP accounting techniques take account of only a subset of total resources used in production. The degree to which this is so for different countries varies with the structure of production and how broadly or narrowly one defines depletable or depreciable resources. But, to some extent, it is true of all countries, since current production almost always involves some use of wasting real assets.

3. Thus Saudi Arabia's case is not unique. Nevertheless, it is, no doubt, on the extreme of the spectrum in two respects: First, the size of its domestic gross "saving" (including resource depletion) is extremely large relative to the capacity of its domestic economy to utilize additional real capital economically -- thus the extremely large amount of Saudi accumulation in the form of external claims. Secondly, a large proportion of Saudi gross saving is really the transformation of depletable resources to other assets. Thus net saving is really much smaller than as conventially measured, probably more so for Saudi Arabia than for most countries.

4. Saudi Arabia, like other countries, must take decisions (a) on the speed with which to transform existing resources into other assets (a vital choice for Saudi Arabia) and (b) the allocation of the proceeds of domestic saving (plus resource depletion and depreciation) between new internal real investment and external asset accumulation (real and financial). In doing so, it must simultaneously balance the marginal social product of its resources left in the ground against the marginal social product of investing in real capital, and these against the marginal social product of investing in external claims. These are highly important choices for Saudi Arabia's future.

5. It seems likely that it is in the interest of Saudi Arabia to (a) undertake a substantial rate of transformation of oil resources into other assets and (b) accumulate external claims where the limited domestic absorptive capacity prevents the transfer of real resources and the marginal social product of accumulated external claims is high relative to the marginal rate of return on domestic investment.

6. Provision of special treatment to OPEC financial assets would be tantamount to our giving them a higher price for their oil. We cannot discuss the price-of-oil questions in the Financial Affairs Commission. Aside from this, we have major theoretical and practical problems with indexation of financial assets and major political problems with any kind of special treatment which is provided on a discriminatory basis.

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DEPARTMENT OF THE TREASURY
Office of the Assistant Secretary

TRADE, ENERGY and FINANCIAL RESOURCES POLICY COORDINATION

The Absorptive Capacity Of The OPEC Countries

September 5, 1975

The Absorptive Capacity of OPEC Countries

Executive Summary

1. The sharp increases in the price of oil in late 1973 and early 1974 and the consequent jump in the revenues of the oil producing countries have generated considerable interest in the question of the absorptive capacity of these countries and the extent to which they will be able to utilize their oil revenues for domestic investment and consumption. The question is central to the issues of real resource transfer, recycling and to the impact of these issues on the domestic economic objectives of the consumer countries.

2. These issues have resulted in a number of efforts to gauge the size and structure of the evolving payments position of the OPEC countries. Little effort, however, has been devoted to analyzing the capacity of individual OPEC countries to utilize domestically (or absorb) oil revenues despite large differences in the economic structure of these countries. Most of the forecasts have been of aggregate imports for OPEC as a whole. A few have attempted to separate OPEC into two groups -- high absorbers and low absorbers and have projected imports for each of these groupings. This study investigates factors which will bear heavily on each country's import levels over the next decade.

3. During the past year and a half, oil revenues have trickled through broad segments of almost all of the OPEC economies, in consequence of sharply rising government expenditures. In most cases public outlays have increased more rapidly than imports and this pattern has been a major factor in intensifying domestic price pressures. There is considerably greater scope for further massive redistribution of oil revenues in OPEC countries, but an effort in this direction is not a prerequisite for sustained high levels of imports. The extent to which OPEC revenues will be redistributed, however, will affect the mix of OPEC imports.

4. The OPEC countries are beginning to face major problems in further expanding their import levels. These problems have become increasingly apparent in the aftermath of the sharp increase in OPEC imports since 1973 which has strained certain facilities in a number of countries to their limits. Most OPEC countries have recognized these constraints, however, and have in train policies and programs to mitigate or overcome them in the framework of their

domestic development plans. The most serious of these constraints are in transportation and manpower. Foreign exchange availabilities are already limiting the import capability of one OPEC country and several others are expected to experience a similar constraint within the next few years.

5. Infrastructure expenditures now have the highest priority in most of the OPEC countries, but many OPEC governments have plans for diversification into industrial activities and establishment of broader agricultural bases. The prospects for successful diversification are uneven and for some countries further development of the energy sector may be the most profitable avenue. Many of the OPEC countries have limited non-hydrocarbon resources and in addition small domestic markets will severely limit the possibility of achieving economies of scale without access to broader regional or world outlets. This access in turn will depend on comparative costs which have not yet been sorted out for many of the plans and projects under consideration. Duplication of effort in some areas which could lead to oversupply problems is also likely to occur. The completion of investment projects in industry and agriculture will frequently result in either increased exports or import substitution, so that the absorptive capacity of these countries will change. The direction of this change will vary from country to country.

6. The Gulf States are least likely to be able to utilize their oil revenues domestically during the next five years, in a reasonably efficient manner. But perhaps only Saudi Arabia and Kuwait will sustain large current account surpluses into the 1980's. On the whole we would expect to see aggregate OPEC imports grow from $37 billion in 1974 to $89 billion in 1980 and to $133 billion by 1985, (all in 1974 prices). This would mean a continuous decline in the annual increase in real OPEC imports from 45 percent in 1974 and 33 percent in 1975, to an average increase of 16 percent annually through the end of this decade, and then to an average increase of only 8 percent from 1980 to 1985. Employing the OECD's forecasts of the growth in OPEC's oil earnings, these import levels would imply an OPEC current account surplus of about $13 billion in 1980, and a cumulative surplus through 1980 of $195 billion, both in 1974 dollars.

7. In comparison, the aggregate OPEC investible surplus in 1974 is estimated at $59 billion which we anticipate will decline this year to a surplus of about $46 billion.

Saudi Arabia and Iran, which accounted for more than half of the aggregate OPEC surplus last year, will have an even more dominant position in 1975, despite extremely large increases in their import levels.

8. The issue of absorptive capacity -- through its determination of how rapidly the transfer of real resources from the consuming to the producing countries will proceed -- relates to several key goals which the industrial countries would seem to have in their relations with OPEC nations. In particular absorptive capacity raises questions with respect to the compatibility of the policies and objectives of the two groups of countries and efforts to ensure that current and prospective oil earnings have minimum disruptive effects on the Western economy and its growth prospects.

9. In the debate that has followed the large and abrupt change in oil prices, there appears to have emerged a preference in many industrial countries for a continued rapid increase in OPEC imports, i.e., a continued rapid transfer of real resources. The preference for present versus future transfers, however, involves a number of complex considerations which have not previously been adequately explored and some of the key arguments in favor of one option or the other fail to hold up under intensive scrunity. Some of the more widely discussed factors bearing on this issue include the effects on: the total level of transfers that would result; the capacity to service OPEC claims; the problem of recycling and cyclical conditions in the major consumer countries.

10. It is far from certain that delayed transfers of real resources will mean a larger total transfer over time. As long as general price movements are as large as pecuniary returns on OPEC investment then the size of the transfer will be unchanged. But recent history indicates a less than complete interest rate accommodation to the rate of inflation.

11. On the other hand, OPEC investment in the consuming countries will not necessarily permit a greater increase in their capacity to service OPEC claims, since export income not only also generates investment capital, but equally important, it increases the demand for such capital through fuller utilization of existing capacity.

12. It is probably impossible for either OPEC governments or OECD governments to develop a trading pattern which will always complement the domestic economic policies of the exporting country, nor would this appear to be necessary.

Export markets cannot predictably be turned on and off with ease and foreign trade has seldom been used successfully as a major counter-cyclical device. On the other hand domestic authorities are able to create or extinguish domestic demand with greater ease, particularly since policy shifts to change overall demand and supply conditions must be taken quickly. Finally, from a micro viewpoint it is not practical to assume that OPEC countries are ready or able to confine their purchases to the more severely depressed sectors of the economy during periods of economic slowdown.

13. Similarly it should not be assumed that the main solution to short-term adjustments in the international payments position of the major consuming countries, either individually or collectively would lie in a sharp acceleration of exports. The ability to increase exports depends upon the pace and manner of implementation of the highly diverse and uncertain plans of the OPEC countries. As a general proposition the high degree of mobility of capital makes short term adjustments through financial flows far more practical than through changes in current transactions. Previous fears that the market mechanism would be incapable of handling such large financial adjustments have proved to be largely unfounded.

14. There is likely to be a significant relationship between the absorption rate of the OPEC countries and their policies with respect to oil production and prices. But the manner in which these relationships will evolve is highly uncertain at the present time. To date the OPEC countries have been able to reconcile their respective revenue availabilities and requirements through selected changes in both prices and production. Whether countries which have excess revenues will be prepared to continue to make adjustments for the sake of countries facing revenue constraints remains to be seen. Similarly, it is not clear whether the success of the development efforts of OPEC governments which would graphically demonstrate the utility of their oil revenues, would encourage them to maintain high revenue levels through higher prices or higher production. Conversely, the failure to utilize OPEC revenues in a productive way could prompt either conservation efforts or lower prices.

15. Regardless of the preference that individual oil consuming countries may have with respect to the timing of real resource transfers to OPEC countries, a number of constraints will intervene which will make it difficult to carry out major policies designed to achieve the preferred result. In the first place, commercial exchanges of the oil

consuming countries are heavily dominated by the activities of private firms who cannot easily be convinced to undertake unproductive ventures, nor sacrifice productive undertakings against the interests of their shareholders and communities. Furthermore, policy decisions which would attempt to channel oil revenues in a particular way could lead to preferential trade and investment policies which would compromise the economic liberalization that has been so painstakingly established in the post-war period.

16. Governments must guard against a tendency toward a competitive race among them for OPEC markets and investment capital, through subsidies, guarantees or the like. Otherwise the total cost of their oil burden could easily increase. Moreover, they must recognize that countries which rely heavily on specific foreign markets are no less vulnerable to them than are countries which rely on specific sources of oil.

17. We would conclude that the appropriate policy framework in the OECD countries for the transfer of real resources to OPEC governments would be one which would maximize the play of market forces. Not only is this likely to prove necessary for practical reasons, but advantageous from the viewpoint of maximum efficiency and world income.

NOTE: Remainder of Document Deleted,

AL, FRIDAY, MAY 22, 1981

Oil and the Saudi Fairy Tale

By Eliyahu Kanovsky

It is widely believed that Saudi Arabia has been doing the West a favor by sustaining its oil production at a high level of 10.3 million barrels a day, and that by granting this favor the Saudis have created the world's current glut of crude oil. This grateful attitude toward the Saudis derives in great part from the fear that the Saudis will make good on their often-stated threat to use the "oil weapon" by cutting the country's oil production to 5 mbd.

What seems to undergird the persistence of these notions is the apparent belief that Saudi Arabia is a country unlike any other, that it is a sort of fairy tale land in which Arab princes sit in grand palaces amidst bags of gold. One of the nice things about fairy tales is that one never has to look too closely at what is going on in the rest of the kingdom. Perhaps it is time to look clearly at the kingdom of Saudi Arabia.

Saudi Arabia is an underdeveloped country. The Saudi population, well aware of the oil revenue flowing into the country and of their rulers' opulence, have strong expectations of higher living standards. Since under the existing regime there is no prospect of income redistribution from the haves to the have-nots, the Saudi solution has been simply to buy the country's way into the developed world.

Saudi Arabia is a casebook study of a country whose expenditures chase – and push – its revenues. Its recently available budget figures indicate the Saudis' plan to spend $90 billion during their current fiscal year, which began earlier this month. If these Saudi expenditure figures hold, their spending will have increased almost five-fold since fiscal 1976 (during its 1975-80 development plan, Saudi spending actually overshot planned figures by about 50%).

Large-Scale Spending

After the Iranian revolution, some observers said the Saudis would realize that such large-scale spending tends to augment destabilizing social forces and that the Saudis would curtail spending. But in an interview with this paper last January the Saudi minister of planning said, "The problems in Iran weren't caused by economic development, but by the lack of it. . . . I don't think our development has been too fast. . . . If I had to do it over again, I would do it the same way."

Saudi Arabia's development began in earnest with the second development plan of 1975-80, which called for total expenditures of $142 billion, an average annual outlay of $28 billion.

What ensued was an influx of foreign contractors and a foreign labor force to build the plan's projects—roads, ports, airports, electric power plants, water desalination, telephones, schools, hospitals and so forth. The bureaucracy mushroomed. There were huge and expensive imports of military equipment and the construction of "military cities." Social welfare programs were expanded.

Various industries have been established, or are in process, and a special government commission was set up with a mandate to develop two major industrial complexes—in Jubail on the east coast and in Yanbo on the west coast.

The Saudi authorities were eager to persuade large multinationals to come in as partners in these ventures, to benefit from their managerial, technical and marketing expertise. But before 1979 (the year in which the Saudis offered extremely attractive participation incentives to the companies), this strand in the Saudi strategy was snagged on what has been one of the most difficult, and costly, drags on the country's development—its labor force.

The Saudi population and its potential labor force are small. Unofficial estimates of the population indicate about four million Saudis. Because women are almost completely excluded from the labor force, the potential force is about one million.

> *Saudi Arabia's many financial 'needs' will do what the record shows they have always done — rise rapidly. And there is only one source for satisfying those needs—oil revenue.*

Thus, the authorities have laid the greatest emphasis on the development of capital-intensive industries, which require a high level of technical and managerial skill. Though individual Saudis have acquired education and administrative and managerial competence, they are few in number. In this respect Saudi Arabia is similar to many other developing countries: Its huge oil revenues and the system they have created provide powerful disincentives to acquiring the sort of skills that enhance a country's long-term productive capacity.

The Saudis have built technical schools in the hope that Saudi youth would pass out of them and into industrial jobs for on-the-job training with foreign technicians, but few Saudis are interested. Far more lucrative alternatives exist for capable Saudis: One can enter government service and use "connections" for private gain, join business ventures with foreigners or act as middlemen for foreigners seeking contracts.

Determined to push forward with their development programs, the Saudis are increasingly dependent on a large, growing foreign labor force—unskilled and semi-skilled workers from the poor Arab countries, Asia and Africa. According to the director general of the Saudi labor ministry, three-fourths of the labor force was foreign by the end of 1979. Back in 1975 Saudi planners said that by 1980 only 35% of the labor force would be foreign. As with their spending plans, it was an optimistic projection.

Apprehensive about these foreigners, the Saudis from time to time apprehend and expel tens of thousands of Muslims from poor countries, who enter as pilgrims and stay illegally, looking for jobs. The result of such measures is an upsurge in wage rates for laborers, another expense.

At the same time, the reluctance of highly skilled personnel, mainly from the West, to live in Saudi Arabia requires foreign contractors to pay three to four times the going rates in the U.S.

The country's work force difficulties put into serious question the viability of its diversification plans, and the Saudi leadership knows it. "The problem now in Saudi Arabia," the deputy minister of industry has said, "is manpower." Current plans call for a standstill in the size of the foreign labor force, with planned increments coming from the Saudi population, but prospects appear dim. Under the best of circumstances it takes decades or generations to educate and train a modern, industrialized labor force.

All these problems notwithstanding, the Saudis' new five-year plan for 1980-85 is costlier still. Total planned expenditures, including military, are $[illegible] billion, a 270% increase over the previous plan. Actual spending for the last plan was about $[illegible] billion, with many projects cut back or dropped. It should come as no surprise if the new plan's actual expenditures again far exceed published estimates.

Lifeblood of the Economy

In short, Saudi Arabia's many financial "needs" will do what the record shows they have always done—rise rapidly. And there is only one source for satisfying those needs—oil revenue, the lifeblood of the Saudi economy. It is this fact of life that lies at the root of Saudi Arabia's relative price moderation.

The Saudi leaders are well aware that the sharp oil price increases in 1973 and 1974 induced trends in world oil and energy markets adverse to long-run Saudi interests. The far greater price increases of 1979-80 greatly accelerated the trend away from oil and toward conservation and energy substitutes like coal and nuclear power.

The Saudis have been very shrewd in successfully capturing a growing share of what is now clearly seen as a shrinking OPEC market. In sharp contrast with the situation in 1978, when others underbid them, the Saudis since 1979 have pursued a policy of keeping their official prices a few dollars below those of other oil exporters and low enough not to speed up the trend to substitutes.

The Saudis' possession of huge oil reserves and their ongoing, far-from-completed plans to diversify the economy—plans that will require a lot of money for a long time—makes them intent on assuring that the future of the oil market is consonant with their needs.

The Saudis' "cushion" of accumulated official foreign assets is indeed much larger than in 1978 (somewhat over a year's public expenditures), but so are their needs. In the absence of any other significant source of income and in view of OPEC's genuinely shrinking market, the Saudis' most prudent option is to enhance oil production and exports, both to increase their current revenues and to moderate oil prices.

Secretary of State Haig and many writers in the American press may persist if they wish in believing that Saudi Arabia is doing the Western world a favor by holding its production at more than 10 mbd. But perhaps one would be paying the Saudis a more straightforward compliment by saying that by keeping production high and prices moderate, they are acting prudently and in the very best interests of a wealthy, underdeveloped country.

Mr. Kanovsky is professor of economics at Bar Ilan University, Israel, and visiting professor at Queens College, New York. This article is adapted from a study to appear in the fall issue of "Middle East Contemporary Survey."

(From Editorial Pages, Washington Post)

Hobart Rowen

Yamani's Nonsense

Sheik Yamani, the oil minister of Saudi Arabia, is a master in the art of communication. For years, he has managed to convince otherwise sophisticated reporters and editors that his country, on behalf of its friends in the West, has exercised restraint in oil pricing.

In a speech to the Foreign Policy Association in New York last week, Yamani spoke of the "sacrifices" his nation is making to keep the United States happy, among them "forgoing $1.9 billion annually in favor of the U.S.A." by maintaining oil prices $4 per barrel lower than the rest of the cartel.

The fact is that the Saudis have a very clear and logical strategy that dictates their oil production and price levels. The $32 Saudi price (compared with $36 for the rest of OPEC) and their production at a sustained level of 10 million barrels a day have everything to do with the Saudis' own best economic interests, and nothing to do with keeping the United States happy.

The most significant development in the world energy market is that oil-producing capacity now exceeds demand, which has been slowed by high OPEC prices. Last year, the Big Seven industrial countries cut oil consumption by 3 million barrels a day, and there is every indication this is the start of a long-run trend.

On "Meet the Press" April 19, NBC's Bill Monroe brought up the matter of the glut, which is weakening oil prices. Guest Yamani answered with a brilliant piece of propaganda later featured by the print and electronic media: "As a matter of fact, this glut was anticipated by Saudi Arabia and almost done by Saudi Arabia. If we reduce our production to the level before we started raising it, there would be no glut at all. So we engineered the glut and we want to see it in order to stabilize the price of oil."

He added that, if Saudi Arabia so chose, it could cut production of 10 million barrels a day to 6 million "and live happily at that level. And if you take away from the market 4 million barrels, then immediately, you will have a shortage. The price of oil will go up." As The Wall Street Journal quipped the next day, "How could anyone refuse to sell AWACS to a bunch of nice guys like that?"

The glut, of course, is a result of several factors, including a depressed world economy caused by high oil prices. In addition, there is the greater economic viability of coal, nuclear energy and other energy sources at these prices, as well as dramatic dividends from conservation. But no one on the "Meet the Press" panel called Yamani's bluff: A reduction of 4 million barrels a day in output would cost his government $48 billion a year (each 1 million barrels a day at $32 being worth $12 billion annually to the Saudis), threatening the viability of the Saudi economy.

The correct reading of Saudi oil production and price policy was given by Yamani himself, in Dhahran, Saudi Arabia, a few weeks ago. Then he had to respond to criticism from a countryman for not going along with the higher prices of other OPEC nations.

"We must not be moved in the direction that other [OPEC] countries are moving in," Yamani said. Saudi Arabia, he continued, is "in a race with time" to establish an industrial base. "If we force the West to invest heavily in finding alternative sources of energy, they will," he continued. "This would take no more than seven years and would result in reducing dependence on oil as a source of energy to a point that will jeopardize Saudi Arabia's interests."

There you have a blunt, clear and defensible statement of the Saudi national interest. It contrasts quite sharply with the nonsense Yamani fed to the Foreign Policy Association about a $1.9 billion "sacrifice" for the good old U.S.A. By keeping the price below the rest of OPEC, Yamani hopes to slow down the shift to alternative sources of energy. It is an intelligent economic decision.

On the other hand, as Yamani said in Dhahran, countries like Algeria, which by 1990 will run out of oil to export, want to push prices as high as possible to maximize their revenue in the short term. "If I were an Algerian," Yamani said, "I would no doubt wish that the price of oil today would reach $100 a barrel—even if I brought the world economy down. Because no matter what happens to the world, they must buy this oil from me regardless of how much I encourage them to look for alternative energy sources. . . ."

But the Saudis and Yamani must take a different approach. Relative price moderation will extend and protect marketability of their oil into the next century. But just as the Saudis wish to decelerate the trend away from oil use and toward coal, natural gas and nuclear energy, it is in America's best interest to accelerate that precise trend, diminishing excessive dependence on imports.

Wall Street Journal (3/30/81)

Saudi Production Cutback An Empty Threat?

By DOUGLAS J. FEITH

The following report appeared a few weeks ago in The New York Times: "'We've gotten no sign of appreciation for everything we've done,' said Ahmed Zaki Yamani, the [Saudi] minister of petroleum, maintaining that Saudi development needs would require oil production of only half the current rate of 10.3 million barrels a day. 'Why should we accumulate a surplus of funds?' Yamani asked rhetorically."

Soon thereafter, the U.S. ambassador to Saudi Arabia, John C. West, announced his thoughts on Saudi oil policy, and they resembled Yamani's. The Saudis are producing "double the amount of oil they need for their own national economy," Mr. West asserted, and added, "If they cut their production to 4.5 million barrels a day they could generate all the money they need for their five-year plan." Mr. West warned that if the Reagan administration's relations with Riyadh "deteriorate," the consequence will be lower Saudi oil production.

Either the Saudis are history's most unusual businessmen or Sheik Yamani has been pulling legs. Yamani frequently tells Western journalists that the Saudis would prefer to produce and sell less oil. "We really hope that we can cut down a little bit as soon as it is possible," he confided recently to the Washington Star.

Such a comment, from an official of a state where oil sales to foreigners account for over 90% of GNP and virtually 100% of exports, seems designed to engender astonishment, if not disbelief. Why should a businessman – a seller of goods – desire less demand for his product and thus less revenue? But Yamani usually pre-empts the question by asserting that the Saudis would actually increase their oil revenues by selling less oil, and that Saudi Arabia anyway has more money than it needs and even more than it wants, so it can best enhance its wealth by taking less oil out of the ground.

Raising Another Question

Such remarks of course raise another question: Why don't the Saudis do the apparently sensible thing and cut their oil production? There is a ready answer to this too. We would do so, Yamani explains, but it would hurt our friends in the West. In the face of such benevolence, what can interviewers say? How about: "I'm skeptical." They never do.

Talk of Saudi satiety, friendship and beneficence should get one reaching for his pocket calculator.

When The Wall Street Journal interviewed Yamani in November 1980, its report noted that Saudi oil production amounted to around 10 million barrels a day (as at present) and the price of Saudi oil was $30 per barrel (it is now $32). In connection with a discussion of the "link" between Saudi oil policy and U.S. foreign policy, the Journal quoted Yamani: "For us, production of three million barrels a day when the price would be $50 a barrel would increase our revenue and conserve our resource. . . . Don't take the Saudis for granted."

A substantial drop in Saudi oil production would mean a substantial drop in the kingdom's revenues. A loss of $150 million a day cannot be sneezed at, even by the Saudis.

Not taking Yamani's figures for granted, I calculated Saudi Arabia's then-current revenue: 10 million barrels a day times $30 per barrel equals $300 million a day. I compared this to the figures Yamani put forward to prove that Saudi Arabia would increase its revenues by lowering its production: 3 million barrels a day times $50 per barrel equals $150 million. To assert that 150 is greater than 300 is a large and rather self-serving miscalculation on the part of the Harvard-educated sheik.

Furthermore, according to prevailing oil demand elasticity projections, it is questionable that a 7 million-barrel-a-day cut in Saudi output would have allowed crude oil prices to rise as much as 66.6% (from $30 to $50). Be that as it may, OPEC's current "oversupply crisis" (which additional production from revenue-starved Iraq and Iran will likely aggravate in the next few months) eliminates altogether the possibility that such a cut by the Saudis would now bring about so great a rise in prices. Thus, a substantial drop in Saudi oil production would mean a substantial drop in the kingdom's revenues. A loss of $150 million a day cannot be sneezed at, even by the Saudis.

Saudi Arabia's ability to sneeze at a loss of reven[illegible] the theme of a feature article this month in the Washington Post. The following items were reported: C[illegible] rent Saudi output is around 10 million barrels a day. Saudi oil sells for $32 per barrel. The Saudi budget this year is $75 billion. Saudi "reserves" (presumably, foreign assets) now equal $125 billion. And Saudi Arabia is adding to these reserves at the rate of $2 billion a month.

That means the Saudis are spending at a rate of around $96 billion a year. The Saudis announced a budget of $75 billion for this year, but they evidently are exceeding it, which conforms with their past practice.

Official figures just released in Saudi Arabia reveal, as reported in The New York Times on March 23, that "last year's expenditures [by the Saudi government] exceeded budgeted allocation by as much as 93% in some sectors." As for the roughly $140 billion budget for its 1975-80 development plan, the Saudi government confirmed a few months ago that the plan actually cost around $210 billion – despite Saudi Arabia's having accomplished, by all accounts, substantially less development than the plan called for.

The $96 billion current spending figure puts into perspective the amount of Saudi Arabia's financial reserves, which Yamani (probably erring on the high side) estimates to be $125 billion; those reserves amount to a bit more than one year's spending for the Saudi regime. It bears noting that despite Yamani's putative preference for oil in the ground over money in the bank, Saudi Arabia has never financed spending by drawing down its bank holdings when it was able to finance it through oil sales at current prices.

In fiscal 1977-78, the Saudi government was forced to reach into its central bank's foreign assets; the government that year had spent all its revenues (oil revenues as well as investment and other income) and incurred a fiscal deficit of more than $4.1 billion.

In the next fiscal year, Riyadh ran up an even larger fiscal deficit over $4.6 billion [illegible] drew down foreign assets ap[illegible]roximately 10%, by more than $6 billion. (An admirable study of Saudi economic policies, written by Queens College Visiting Professor E. Kanovsky will appear in the forthcoming "Middle East Contemporary Survey" published by Holmes & Meier in New York.)

Crude oil prices are too high to allow all the OPEC countries to sell all the oil they are producing; hence the grumbling among the oil states about production cuts and price reductions. If, as Yamani predicted in the Post article, Iraq and Iran add 7 million barrels a day to world supplies and this forces Saudi Arabia to cut its output by 5 million barrels a day, the Saudi cut will not force prices up; total world supplies will remain at least as plentiful as at present (even if other smaller exporters feel compelled to reduce their production somewhat), with Iranian and Iraqi production simply displacing that of Saudi Arabia.

Grim Tale for the Saudis

Under these circumstances, a Saudi production cut from 10 million to 5 million barrels a day would cut Saudi revenues in half – from the current $120 billion a year to around $60 billion. But official Saudi spending is at the rate of $94 billion a year, and thereby hangs a grim tale for the Saudi regime.

Therefore, notwithstanding Yamani's bold front and Ambassador West's dubious insights into Saudi fiscal requirements, Saudi Arabia can be counted on to persist in seeking ever higher revenues, even in periods when it is accumulating a current-account surplus, and to resist (so long as market conditions allow resistance) pressure from whatever source to cut Saudi output. (Note that the real pressure for a Saudi production cut comes not from the Saudi populace, which benefits from high Saudi revenues, but from the other oil-exporting states, which wish to be spared the necessity of having to cut their own production or prices when the market goes "soft.")

Saudi Arabia produces and sells as much oil as it can find customers for at current prices. It does so because its rulers enjoy wealth and wish to preserve their rule. Whether those rulers are "pro-Western," "friendly" or pleased with any or all of the elements of U.S. foreign policy is an issue "linked" to Saudi oil policy only in diplomatic rhetoric and in the minds of those who do not actually bear responsibility for turning Saudi oil into [illegible]

Mr. Feith [illegible] general couns[illegible] Center for International [illegible] Washington

Wall Street Journal (4/21/81)

The World's Falling Need for Crude Oil

By S. Fred Singer

During 1980 U.S. oil consumption dropped once again, by 8% compared to 1979; imports dropped by 20%. These figures seem to reflect not a mere fluctuation, but the beginning of a long-term and irreversible decline from a 1978 peak of 18.8 million barrels per day. Between 1978 and 1980 also, fuel oil use by U.S. utilities declined by one-third, or by 0.56 mbd. Similar trends and structural changes in oil use are evident throughout the world, and they will accelerate as cheaper energy sources—coal, nuclear—replace oil to produce heat and steam.

Only about one-third of the world's oil consumption of around 60 mbd is now refined into fuel for transportation; most of the rest goes into fuel oil. Total energy use throughout the world will indeed be greater over the next decade, but when the alternatives to fuel oil come on stream over this period, oil use will have been cut by a factor of two or more—to some 20 mbd worldwide.

Oil then will be reserved for transportation and other uses where substitutes are not economical. And refineries will be operating to meet this changed demand.

Impetus to Conserve Oil

The driving force behind this development is economics, with the 1979 doubling of world price providing the final impetus to conserve oil and switch fuels. Unless OPEC makes a heroic effort to drop the world price within the next year or so, the industrial countries will move ahead rapidly with capital investments which effectively lock them into a low oil-use scenario. The current oil glut has raised serious concern among OPEC members, but they are not likely to "bite the bullet." Instead, the OPEC meeting next May will probably try to get Saudi Arabia and others to reduce production so as to firm up current prices.

This decline in oil consumption has been reinforced by the recent deregulation of oil prices in the United States. Deregulation's most far-reaching effect will be on the refining industry. As the market for fuel oil disappears, as much as one-third of refining capacity here, and perhaps two-thirds of capacity abroad, will become surplus. The remaining refineries will be upgraded to produce more gasoline and less fuel oil from crude oils, which are becoming heavier and contain more sulphur.

The premium prices being paid for light, sweet crude also provide economic incentives for the billion-dollar investments required for refinery conversions. Another factor forcing smaller and less efficient refineries to close down is the demise of the subsidy from the Crude Oil Entitlement Program, which was in effect while U.S. oil prices were still regulated.

For the first time in many years U.S. refiners will face foreign competition. They had been protected in the past by lower crude oil costs set through price regulation, and by import duties on oil products. Their only serious competition is the residual fuel oil that comes from Caribbean refineries—assuming the Reagan administration does not adopt protective measures, such as import fees. This competition will push U.S. refineries even faster toward making more gasoline. The oil industry is making these major adjustments in response to market forces, without specific government help or advice.

Unless OPEC makes a heroic effort to drop the world price, industrial countries will move ahead with capital investments locking in a low oil-use scenario.

In other areas, however, government involvement will continue to be important, irrespective of whether the Department of Energy survives.

The complex administrative machinery created to enforce all the ramifications of price regulations can be dismantled, but government is likely to have an important role in technology for advanced energy sources, such as solar, geothermal, nuclear breeders and nuclear fusion—with attention paid to advances made in these fields by other countries.

One major governmental decision concerns the early deregulation of natural gas. Deregulation of gas would send the right signals to consumers on whether and what to substitute for oil. And it would allow coal to emerge as the cheapest fuel for heat, further encouraging its use by industry and electric utilities. Residential users will be encouraged to conserve gas, and they may find electricity or solar technologies, both passive and active, to be worthwhile.

Government must also address itself to the conflict between energy development and environmental protection. This conflict cannot be "wished away." At the least, government has to conduct environmental protection in a rational manner by balancing costs and benefits with an emphasis on equity to assure that those who pay also receive benefits, and vice versa.

It is generally recognized that the Clean Air Act and the related regulations form a barrier to the wider use of coal. The act is up for reconsideration in 1981, but even without fundamental changes much can be done to make regulations more flexible. For example if abundant low-sulphur Western coal is allowed to be in compliance with standards without further costly stack-gas cleaning, it would greatly enhance the use of this cheap fuel. That decision would free up Eastern coal supplies for export, making the U.S. a net exporter of energy fuels by the end of the decade.

With respect to power plants and especially nuclear plants, government can speed up the licensing process by selecting and approving possible sites well in advance and placing them in an "inventory," and by encouraging standardized nuclear plants.

Together with deregulation, barriers to the leasing of federal land, onshore, offshore and in Alaska, should be removed to allow the development of the most promising oil and gas properties. It is irrational to hold back domestic oil development: The federal government—and the taxpayers—benefit not only from bonus payments, royalties and production taxes, but from lower energy imports.

With oil consumption dropping rapidly throughout the world, the need for a crash program for synthetic fuels disappears. Government support for demonstration plants to observe the technology and economics of turning coal into synthetic gas or synthetic oil may be justified, but a government-subsidized synthetic fuels industry is probably no longer on the horizon.

The impact of energy on national security must be a primary concern of government. Oil embargoes as such have never been effective in cutting off oil from the U.S., not even in 1973-74. Oil is a fungible substance and can always be purchased from other sources. If proof is needed, consider the self-imposed embargo Jimmy Carter declared after the U.S. embassy takeover in Iran. Had Khomeini stopped oil sales to the U.S., it probably would have created a panic here.

With oil prices deregulated, we will no longer see long lines at gasoline stations. If supply interruptions should occur, by intention or accident, prices would provide an efficient, automatic allocation mechanism.

Reduced Need for Imports

One aspect of declining world oil demand is the reduced need for imports. OPEC production will drop severely as many regions of the world become more self-sufficient. Foreign oil needed by the U.S. is likely to come from North America. Under these changed circumstances, the federal Strategic Petroleum Reserve may be one of those great ideas whose time has come—and gone. In any case it should be possible to scale it down (Jimmy Carter even raised it from 500 million barrels to one billion). We may be able to fill it at lower cost by buying OPEC oil cheaply when it becomes surplus. Or we may be able to strike a bargain with Mexico regarding oil supplies during emergencies.

OPEC members may decide to cut prices to sell their oil on the world market and to maintain the income they badly need to feed their overgrown national budgets. Congress may then step in to protect domestic energy investments, such as tertiary oil recovery or shale oil projects. Pressure from domestic energy producers may force the U.S. to establish tariffs or import restrictions for overseas oil and petroleum products.

The situation could become immensely complicated, especially if other industrial countries do not follow this route. It would indeed be ironic if we were to return—if only for a few years—to the mandatory oil import quotas of the Sixties to ward off cheap OPEC oil in the Eighties.

Mr. Singer is a member of the Energy Policy Studies Center of the University of Virginia. He earlier served as deputy assistant secretary of Interior and as a consultant on energy economics and security for Energy and Treasury Departments. An editorial about the OPEC dilemma appears today.

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TREASURY DEPARTMENT

Document No. F-41

SUMMARY OF MAIN POINTS FOR A MEETING BETWEEN A HIGH LEVEL TREASURY OFFICIAL A HIGH LEVEL OFFICIAL OF A MIDDLE EAST OPEC COUNTRY

1. Conditions in the exchange markets have improved due to the OPEC decision to freeze oil prices and reduced uncertainty about US exchange rate policies. Confidence still fragile.

2. A shift from the dollar as the oil pricing unit at this time could be misinterpreted as a reversal of the decision to maintain the price of oil unchanged and as a change in OPEC investment policy. The move could precipitate a serious reaction in the exchange market and perhaps other markets that would not be in the interest of the Middle East OPEC country or the U.S.

3. An exchange market crisis could adversely affect the Middle East OPEC country's economic and political interests and undermine U.S. ability to exercise political and economic leadership.

4. Although recent exchange market developments have reduced the dollar's purchasing power relative to the purchasing power of other major currencies, this development represents a reversal of the gains in relative purchasing power achieved in the period from mid-1975-mid-1977. These offsetting changes leave the dollar approximately unchanged relative to other major currencies.

5. In practical terms, given the relative size of the U.S. economy, the Middle East OPEC country's ability to offset a loss in dollar purchasing power is very, very limited. There are simply not enough top quality assets available in non-dollar currencies and attempts to shift will only depress the value of the dollar investments which will have to continue to be the dominant holdings.

6. The recent exchange rate changes do not reflect any fundamental weakness in the US economy. There is no reason why the dollar should continue to fall on a trade-weighted basis. The Middle East OPEC country will want to look at the medium to longer term.

   -- Our economy is out-performing all others in growth and nearly all others in its control of inflation.

   -- Our trade deficit is more the result of slow growth elsewhere than anything else. It will decline when other countries begin to recover.

-- We are beginning to conserve energy and will soon have an overall energy bill.

-- U.S. competitive position remains strong.

7. U.S. is likely to remain an attractive place to invest, with political stability, respect for contracts, no capital controls, and economy growing $100 billion per year. That outlook has to be weighed against situation elsewhere.

-- Moreover, U.S. provides only financial market capable of accommodating the Middle East OPEC country investment needs.

-- Some other European countries realize their economy is much too small to underwrite the volume of foreign holdings being denominated in their country's currency and are unlikely to tolerate large increases. One European country had made it clear they do not want their currency to become a reserve currency.

Elaboration of Possible Points

Talking Points

-- The US is determined to maintain a sound dollar and to avoid depreciation unless it is a reflection of underlying resources and financial performance. The announcement on January 4 that Treasury resources would be used in conjunction with those of the Federal Reserve for intervention demonstrated forcefully our determination to re-establish order and curb speculation in the foreign exchange market.

-- Market conditions have improved. No significant U.S. intervention has been necessary for the past three weeks. Important factor has been OPEC decision to freeze oil prices; reduced uncertainty about U.S. exchange rate policy; and Japanese commitment to spur growth and reduce trade surplus.

-- Confidence remains fragile, however, and we are alert for possible new disturbances. Because markets are still disturbed, we have been concerned about reports that a Middle East OPEC country may propose shifting the basis for oil pricing from the dollar to some form of currency basket.

-- The choice of the unit of account for oil pricing is basically a decision for the producing countries. Such a shift at the present time, however, could be misinterpreted as a reversal of decision to maintain present price of oil, as a lack of confidence in the dollar and as presaging shift in OPEC investment policy away from the U.S. It could precipitate a serious market which reaction would be neither in your interest or ours.

-- A major exchange rate crisis would:

a) Underline efforts to spur economic growth and reduce unemployment both in the US and abroad by adversely effecting business investment and consumer spending.

b) Create major disturbances in money, capital and commodity markets that could threaten the stability of the international monetary system and be especially harmful to the Middle East OPEC country's financial interests.

c) Increase protectionist pressures in the US as sentiment grew to curb imports as a means of aiding the dollar. Other countries would also seek to protect their economies from the dollar's decline.

d) Detract from US ability to exercise leadership in world affairs, both political and economic.

e) Foster increased political instability in Europe and elsewhere that would be inimical to Saudi interests.

-- The US recognizes that recent exchange market developments have reduced the dollar's purchasing power relative to the purchasing power of other major currencies. Our calculations indicate that as of December 1977 the relative purchasing power of the dollar was essentially equal to that of early 1974 -- the period immediately after the major oil price rises. (See Tab F.)

-- A shift in the basis of oil pricing would not be a solution, however.

a) Financial markets:

(1) The US provides the only financial markets capable of accommodating the Middle East OPEC country's large investment needs. Over 50 percent of the securities floated by all borrowers in the major financial centers are floated in the US.

(2) The Middle East OPEC country already has a huge stake in US capital markets. Any suspicion of a loss of that country's confidence in the dollar would trigger a sell off that would sharply reduce the capital value of existing assets.

(3) It is highly unlikely that other potential recipients of large investments would be prepared to accept the exchange rate consequences and would probably impose

stringent capital controls.

b) <u>Terms of trade of the Middle East OPEC country</u>:

(1) Our figures show that the export prices of the Middle East OPEC country's principal suppliers have in fact risen slightly less than oil prices. Since the major oil price increases in 1973/74, the export prices in dollar terms of the goods sold to the Middle East OPEC country by its major suppliers have increased by about 29 percent. The price received by OPEC for oil during that period increased by more than 32 percent. (Table available for distribution at Tab E.)

(c) <u>SDR basket</u>

(1) No unit of account can provide full protection against exchange rate movements. The dollar value of the SDR has only recently returned to the mid-1975 level. If SDR pricing had been in effect during the past two years, oil revenues would have been lower than dollar pricing. (See Tab H.)

(2) A shift to the SDR would provide only a temporary respite from pressures within OPEC. Whenever the SDR's value declined, some OPEC members would seek changes in the pricing unit. In effect the pricing unit would become a disguised mechanism for raising prices.

-- In reaching a decision the Middle East OPEC country must assess longer term trends. Recent exchange rate changes do not reflect any fundamental weakness in the US economy.

a) Our trade deficit in large measure reflects the fact that our economy is outperforming other major industrial countries. As others catch up, our deficit should decline.

b) Our inflation rate compares favorably with others and recent exchange rate changes should improve our competitive position.

c) US interest rates are above those of most industrial countries. Interest rate differentials between the US and another European country are not expected to narrow in the near future.

d) The US is likely to remain an attractive place to invest. The President's economic program will ensure an economy that is growing by $100 billion per year. We have a stable political system, freedom from capital controls, and a respect for private contracts.

e) An energy program should be enacted in the near future which will have a beneficial psychological impact on the market and initiate a nationwide effort to reduce excessive energy imports.

-- We hope that the Middle East OPEC country will continue to work with us in maintaining a stable system and take full account of the larger interests involved in any decision to alter unit for oil pricing.

February 1978

TREASURY DEPARTMENT

Document No. F-14

TALKING POINTS FOR A CALL FROM A HIGH LEVEL TREASURY OFFICIAL TO A HIGH LEVEL OFFICIAL OF A MIDDLE EAST OPEC COUNTRY

1. We have been concerned about reports that a Middle East OPEC country is calling for an increase in oil prices to compensate for the recent fall of the dollar in the foreign exchange market and a shift from the dollar as the unit for oil pricing. These statements, and a call for an OPEC meeting on the issue, are complicating our efforts to deal with market disorders and could precipitate a major market reaction that would be neither in your interest or ours.

2. The US is acting forcefully to deal with market disorders.

   a) As the disorders have increased, so has our intervention. In the period November-January U.S. intervention amounted to $1.5 billion.

   b) The March 13 joint U.S./German statement should provide a clearer understanding of U.S. and German policies and put to rest some of the rumors which have been adding to the disorder.

   c) Substantial additional resources are available to the U.S. and we are prepared to use them if necessary to counter disorder.

3. Most importantly, we are planning measures to reduce our excessive dependence on energy imports and on inflation. We hope to announce actions within the next few days.

4. I am confident that by dealing with the fundamentals as we propose to do, and by our bridging actions to counter disorderly markets through intervention, we will restore stability to the markets and protect your interests as well as ours.

5. We appreciate that recent purchase market developments have reduced the dollar's purchasing power relative to that of other major currencies. Our calculations indicate that as of December 1977 (the latest date for complete data) the relative purchasing power of the dollar was essentially equal to that of early 1974 -- the period immediately after the major oil price rises. (Offer to send a Treasury staff paper containing our analysis.)

6. In practical terms, given relative size of the US economy, the Middle East OPEC country's ability to offset a loss in dollar purchasing power is very, very limited. There are simply not enough top quality assets available in non-dollar currencies and attempts to shift will only depress the value of the dollar investments which will have to continue to be the dominant

holdings.

7. Moreover, a shift in the basis of oil pricing is not warranted and would not be a solution:

a) OPEC's terms of trade have not deteriorated since the major oil price increase of 1973/74. The export prices in dollar terms of goods sold to OPEC by its major suppliers have increased about the same amount as the OPEC "government take" from oil.

b) No unit of account can provide full protection against exchange rate movements. The dollar value of the SDR has only recently returned to the mid-1975 level. If SDR pricing had been in effect during the past 2-1/2 years, oil revenues would have been lower than with dollar pricing.

8. Recent exchange rate changes do not reflect any fundamental weakness in the U.S. economy. The current account deficit should be financeable once markets can calm down a bit and recognize that the situation is improving. The Middle East OPEC country will want to look at the medium to longer-term trends.

a) Our economy is out performing all others in growth and our deficit largely reflects the slow growth in other major countries. The expected convergence of growth rates in 1978 should bring an improving trend by year end. An increase in oil prices could, however, abort recovery and exacerbate payments imbalances.

b) Our inflation rate compares favorably with others and recent exchange rate changes should improve our competitive position.

c) U.S. interest rates are above those of most major industrial countries. Interest rate differentials between the U.S. and Germany are not expected to narrow in the near future.

d) The U.S. is likely to remain an attractive place to invest. We provide the only financial market capable of accommodating the Middle East OPEC country's large investment needs. One European country realizes its economy is much too small to underwrite the volume of foreign holdings being denominated in that country's currency and are unlikely to tolerate large increases. One European country has made it clear they do not want their currency to become a reserve currency.

9. We hope that the Middle East OPEC country will continue to work with us in maintaining a stable system and take full account of the larger interests involved in this matter.

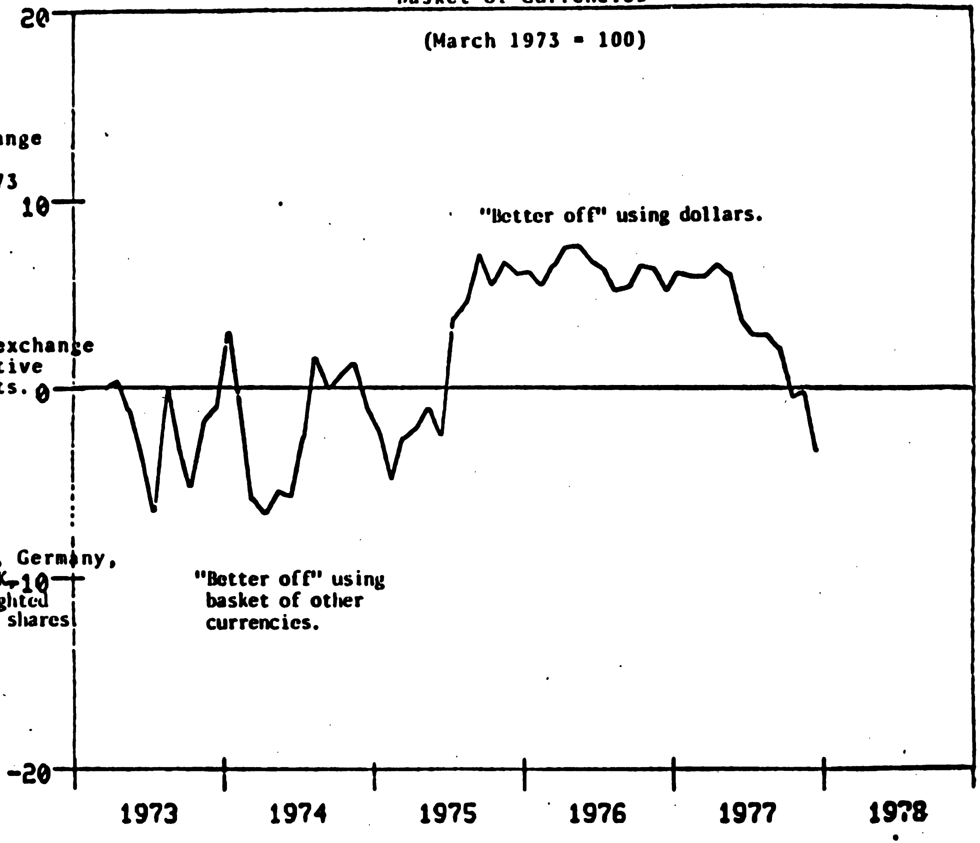
MOVEMENTS IN RELATIVE PURCHASING POWER OF DOLLAR DENOMINATED ASSETS

	Jan.	Feb.	March	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
1973			0.0	0.4	-1.1	-3.7	-6.4	0.1	-3.1	-5.1	-1.7	-1.0
1974	2.9	-1.8	-5.8	-6.5	-5.4	-5.6	-2.6	1.6	0.0	0.8	1.3	-1.0
1975	-2.4	-4.8	-2.6	-2.1	-1.1	-2.5	3.6	4.5	7.0	5.4	6.6	6.0
1976	6.1	5.4	6.4	7.4	7.4	6.6	6.3	5.1	5.3	6.4	6.3	5.0
1977	6.0	5.8	5.8	6.4	5.9	3.5	2.7	2.8	2.1	-0.5	-0.3	-3.4

Relative Purchasing Power is defined as price and exchange rate adjusted value of U.S. versus the trade weighted (by import shares) average of German, Japan, Canadian, U.K., French, Italian, and Swiss currencies.

Movements in Purchasing Power of Dollar holdings 1/ Relative to a Basket of Currencies 2/

(March 1973 = 100)



1/ Adjusted for exchange rate and relative price movements.

2/ Canada, Japan, Germany, France, Italy, UK, Switzerland. Weighted by import shares

Comparison of percent changes in alternative estimates of industrial countries' export prices to OPEC and in estimates of OPEC's oil price per barrel 1/

Period	Germany, Japan and United States		14 Industrial Countries		Estimate of OPEC price per barrel
	Export Prices	Export Unit Values	Export prices for Germany, Japan, U.S. & unit values for Other 11	Unit Values	
1974 I to 1975 I 2/	9.7	16.3	16.6	20.6	9.6
1975 II to 1976 IV 3/	3.9	7.1	3.7	5.6	10.0
1976 IV to 1977 III 4/	5.9	4.2	6.9	5.7	10.3
1974 I to 1977 III 5/	20.7	29.8	29.2	34.6	31.6
1970 II to 1977 III	91.0	102.8	101.9	108.7	1249.2

Source: U.S. Bureau of Labor Statistics. See U.S. Department of Labor, Estimating Price Trends of Industrial Countries' Exports to OPEC, Bulletin 1969, for basic methodology.

1/ All indexes reflect dollar cost and were aggregated using each industrial country's share of exports to OPEC in 1974.

2/ Time period chosen to approximate time span of first OPEC price freeze.

3/ Time period chosen to approximate time span of second OPEC price freeze.

4/ Time period chosen to approximate time span from beginning of OPEC third oil price freeze to most recent period.

5/ Time period chosen to approximate time span from beginning of OPEC first oil price freeze to most recent period.

February 7, 1978

(A Federal Reserve Board memo)

August 28, 1975

Mr. Pizer

Alex Lang

Current Investment and Financial Issues of Kuwait.

According to Kuwaiti officials, all oil payments to Kuwait are currently made in dollars. All funds are initially placed in the U.S. money market, which is being used as a transit station. From the U.S. market, Kuwait then makes its world-wide investments. Around per cent of Kuwait's funds (about , at the end of 1974) are kept in dollars. About per cent of income is kept in reserve in short-term assets to cover budget and other current expenditures. The remaining per cent are earmarked for longer-term investments. Kuwaiti officials believe that only the U.S. and the U.K. money markets can absorb their funds in smooth and timely fashion, but they worry about the strength and stability of the Dollar.

On a number of occasions Kuwaiti officials wondered whether the U.S. Government was interested in facilitating Kuwaiti investments in this country. They pointedly referred to some tax advantages purportedly offered to them by the French Government. Nevertheless, direct investments in the United States by the Kuwaitis were estimated to reach by the end of 1974 some As for Kuwait itself, it has recently moved to take over the entire oil industry. Foreign ownership of banks is not allowed, but minority ownership by non-Kuwaitis in non-bank financial institutions (investment companies) does exist. Land ownership in Kuwait is strictly limited to Kuwaiti citizens only.

C. U.S. GOVERNMENT PREFERENTIAL TREATMENT TO KEEP SECRET MIDDLE EAST OPEC COUNTRY INVESTMENT STATISTICS AND REASONS THEREFORE

[Subcommittee note: Many of the documents bearing on this subject were previously published in Hearings before a Subcommittee of the Committee on Government Operations, 96th Congress, "The Operations of Federal Agencies in Monitoring, Reporting on, and Analyzing Foreign Investments in the United States (Part 5—Appendixes)".]

No. I-3

SUMMARY OF A CABLE CONCERNING A MEETING OF A HIGH LEVEL US TREASURY OFFICIAL WITH A HIGH LEVEL OFFICIAL OF A MIDDLE EAST OPEC COUNTRY

DATE: Fall 1977

* * *

[Pursuant to Agreement with Treasury Department, material deleted. (Material does not deal with issue of secrecy/disclosure.)]

Disclosure. A foreign government official said that his country did not desire special treatment for its investment in the U.S., but if its investment were to continue, it should not be harrassed by disclosure legislation, especially since its behavior as an investor was impeccable. The official said that his country was a very correct foreign investor, in that it scrupulously avoids speculation. Also, very rarely do investments exceed 2 percent in a given company. The country wants to diversify; in fact, it is putting new money into individual states in the U.S. The country is extremely sensitive to disclosure legislations. If such requirements were to come into effect, to the extent possible, the country would reduce its investments and cut its oil production to reduce its financial surplus even though it knows this is not good for the oil market.

A high level Treasury official replied that the Senate had approved modifications of disclosure legislation which only required disclosure of investments totaling over 5 percent of the equity of a company. The House of Representatives had not yet acted but it appeared that it would follow the Senate's lead. There is no question that the U.S. capital market was open to investment from the Middle East OPEC country on a much larger scale than the markets in Western Europe, where surplus countries such as Switzerland and Germany would not hesitate to penalize large inflows of foreign capital through imposing negative interest rates, if need be. According to the Treasury official, in comparison, the United States, particularly because of its lief in maintaining free market forces, had gone out of its way o avoid hindrances to the inflow of foreign funds.

SUMMARY OF DOCUMENT FURNISHED BY
U.S. EXECUTIVE BRANCH AGENCY

UNCLASSIFIED SUMMARY

MEMORANDUM - JULY 1979

SUBJECT: Meeting with Senior Official of Mideast OPEC Government

Embassy Officers reported to Senior Mideast official that in current Congressional hearings on OPEC Investment in the U.S., Assistant Secretary of the Treasury, C. Fred Bergsten, had held firm in the assertion of Treasury's long-standing policy with regard to disclosure of holdings in the U.S. on a country-by-country basis. We also provided the official with a copy of the statement, "Congressional Hearings on OPEC Investment in the United States", which had previously been given to the Foreign Ministry.

The official's response reflected polite resignation in face of what he views as an unfavorable Washington political scene. He did not see how a Congressional subpoena for public release of such confidential information could have anything but an adverse impact on his government's investment policy vis-a-vis the U.S.

He also took the opportunity to register his government's concern about another problem that affects its investment portfolio, the recent weakness of the dollar. He expressed the hope that this dollar decline would be quickly rectified.

Moving on to tax issues, we informed the official that Treasury lawyers are continuing to prepare responses to his previous inquiries on tax matters, including the issue of possible tax treaties or informal tax agreements, among other matters. The official involved had previously discussed with Treasury tax experts a number of these tax issues including final draft regulations on the separate entity question re: Taxation of income derived by foreign governments and government entities, and the question of how income from U.S. private placements would be taxed.

UNCLASSIFIED SUMMARY
CABLE 11
FROM: US EMBASSY
TO: DEPARTMENT OF STATE
JULY 1979

SUBJECT: Discussions with Middle East OPEC Government Official on Taxation of Foreign Investment and Rosenthal Hearings

1. Embassy officers yesterday briefed foreign government official on upcoming Rosenthal Hearings and on Treasury proposals regarding taxation of foreign investment in U.S. real estate, drawing extensively on points made in Department's cables.

2. Foreign government official, who had just come from meeting with chief of government, expressed concern about effect of Rosenthal hearings. Besides sensationalist publicity in the U.S. press they were likely to lead to equally overblown coverage in local press, and to pressures from those who know nothing about international investment for his government to shift investment out of the United States. In the past few weeks European bankers and others have been flocking to his country urging government to put more money in European countries and Eurodollar accounts. Foreign government official said he has resisted such pressure since he still believes U.S. is the best place for much of his government's long-term investment. However Rosenthal hearings and attendant Brouhaha might lead to move of some of its funds from U.S. into the Eurodollar market.

3. Drawing on Department cable, embassy officer emphasized that Treasury statement would challenge GAO assertions that USG agencies are not justified in withholding data from Congress on details of individual countries investments in the U.S. Foreign government official took point and seemed more concerned by publicity hearings would generate than actual risk of disclosure.

Page 2 - Cable 11

4. Taxation of foreign investment in U.S. real estate (Section 892): Through U.S. financial institution, foreign government official had received Treasury Department May 79 report on taxation of foreign investment in U.S. real estate, but not June 25 statement by Assistant Secretary for Tax Policy Lubick, which embassy officer provided. He added that U.S. manager of his government's real estate investment portfolio in the United States would arrive soon for discussions of what his government should do in response to proposed Treasury changes in taxation of foreign real estate investment.

5. Since 1973, government here has repeatedly expressed sensitivity over divulgence of information on its investments in the United States or calls that such information be divulged. Rosenthal hearings are likely to reinforce feeling of many government officials that this country would get a better return on its one asset, oil, by leaving it in the ground than by producing above the country's needs. Latter course, they are likely to argue, not only leads to real loss through inflation, but also to vituperative and "racist" attacks in the U.S. on the very investment made necessary by oil production above the country's financial needs. Many of this country's officials are especially sensitive to such attacks, believing them to be inspired by anti-Arab sentiments.

6. We would appreciate receiving text of testimony of USG witnesses before Rosenthal committee, with as extensive summaries as possible by wireless file.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM.

Office Correspondence

Date August 2, 1974

To Mr. Irvine

From Alex Lang

Subject: Discussions between US Treasury experts and Kuwaiti officials

According to the attached cable from Kuwait, two Treasury experts specializing on international financial flows resulting from oil trade, Shotts (senior economist in the Research and Balance of Payments Analysis Section of OASIA) and McCullough (international economist) have recently been in Kuwait. Their extensive discussion with the Kuwaiti officials of the international petroleum situation and OPEC pricing policies has revealed some basic differences of opinion on these issues between the two parties. The discussion, however, has been useful in helping to expose the Kuwaitis to new ideas, and is believed by the US Embassy officials to be a promising way to persuade Kuwait to re-examine its present oil pricing and production policies.

Kuwait's current oil production and pricing policies are primarily determined by the conditions and prospects for their foreign investments of surplus funds. It is not clear from the cable whether these issues have been discussed . However, it is most likely that a considerable difference of opinion and perception exists between the two parties on the international financial situation as well.

Union Calendar No. 757

96th Congress, 2d Session - - - - - - - House Report No. 96-1216

(EXCERPTS FROM:)

THE ADEQUACY OF THE FEDERAL RESPONSE TO FOREIGN INVESTMENT IN THE UNITED STATES

TWENTIETH REPORT

BY THE

COMMITTEE ON GOVERNMENT OPERATIONS

together with

ADDITIONAL VIEWS

AUGUST 1, 1980.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

U.S. GOVERNMENT PRINTING OFFICE

WASHINGTON : 1980

(FROM CHAPTER IV, "Findings and Conclusions")

D. DATA REPORTING

I

(Confidentiality and Refusals to Share Data)

48. The Treasury and Federal Reserve Board publish country-by-country data on foreign portfolio investment in the United States, but, since the period of 1974 and 1975, they have not published or otherwise disclosed that data for the Middle East OPEC countries. This non-publication and nondisclosure result from an informal agreement or arrangement between the U.S. Government and Saudi Arabia and Kuwait to give those nations' investments preferential treatment. As part of that treatment, the dollar amounts for each type of investment will be kept confidential. The U.S. Government has carried out this agreement by publishing Saudi and Kuwaiti investments in several country aggregates (such as "Other Asia," "Other Africa," or, finally, for the subcommittee, "Middle East OPEC").

(a) Secretary of Treasury William Simon entered into the initial arrangement in 1975, as a quid pro quo for massive Saudi investments in U.S. Government securities. The agreement, however, applies to all Saudi and other Middle East OPEC country investments.

(b) Contrary to Treasury's testimony, the Carter Administration is strictly observing the agreement by refusing to publish or to share this data with Congress and U.S. Government agencies, which need the data.

(c) The Treasury's and the Fed's reliance upon the confidentiality provisions of the Bretton Woods Agreement Act and the International Investment Survey Act of 1976 as a basis for this mandatory nondisclosure policy has no legal validity.

(i) While the confidentiality provisions in the two statutes are mandatory, Treasury has applied them in a way so that they do not cover other foreign government investments. First, Treasury testified that it would honor the request of any foreign government to keep that country's assets in the United States secret, if the foreign government (and not private investors) held the bulk of those assets. Secondly, Treasury and the Fed have, in fact, published country-by-country investments of the Eastern Bloc countries (including the Soviet Union), the governments of which hold almost all of the investments.

(ii) The ultimate purpose of the confidentiality provisions was to protect private investors, and not massive governmental institutions.

(iii) Subcommittee review of pertinent documents establishes beyond a doubt that nondisclosure is predicated, not on legal restrictions but on political concerns of Treasury, State, and the Fed about displeasing the Saudi, Kuwaiti and possibly other Middle Eastern Governments.

(iv) On many occasions these Middle Eastern Governments have advised the U.S. Government that their investment policies are based on favorable investment opportunities but that disclosure of investments would create a climate inhospitable to their investments.

49. Treasury refuses to share this data with other Federal agencies, even though Section 5(c) of the 1976 Act expressly authorizes the sharing of data collected under that act, under arrangements to protect confidentiality:

(a) Treasury refused to share Iranian investment data with the high-level ad hoc Iran Consultative Group (made up of Defense, Energy, State, CIA, ICA, Treasury, and National Security Council (NSC) representatives), which needed the data to assess the consequences of a possible Iranian withdrawal of assets from the United States. (Treasury was prepared to pressure the superiors of the NSC official who was pressing for the data.)

(b) Treasury refuses to share OPEC country-by-country data with Commerce's BEA, which requires and wants the data for balance-of-payments purposes and for analysis of various financial issues raised by these investments.

(c) While Treasury technically shares OPEC country-by-country data with the Federal Reserve Board, Treasury's agreement with the Fed as to that data does not allow Fed Governors or high Fed officials access to such data.

50. (a) While not refusing to share OPEC investment data with the CIA, Treasury Secretary Blumental indicated displeasure directly to the Director of the CIA about the public release of some foreign government investment statistics and requested that the data not be

disseminated even on a classified basis, to any person or entity including Congress, without Treasury's permission.

(b) CIA Director Turner indicated to the Secretary of Treasury that refusal to share data with Congress might violate Executive Order 12036, which mandates the availability of "national foreign intelligence" information to the Congress. However, because CIA believed that disclosure would have "adverse" consequences, it complied with Treasury's request. As a result, the CIA refuses to release country-by-country OPEC investment data, without Treasury's permission.

(c) CIA's refusal to release such data with the Congress appears to violate Executive Order 12036.

51. The Treasury and the Fed have refused to share OPEC country-by-country investment data with the Commerce, Consumer and Monetary Affairs Subcommittee, even under arrangements to protect the confidentiality of this material. In May or June 1979, the Saudi Government expressed strong concern to the U.S. Ambassador to Saudi Arabia about the subcommittee's investigation and about possible disclosure of OPEC portfolio investment data. In response to Saudi concerns about the subcommittee's investigation, Treasury and the Fed have withheld the data from the Congress. These agencies' refusals constitute a violation of Congress' constitutional rights of access to information in the Executive branch, in connection with Congress' legislative and oversight responsibilities:

(a) According to a July 19, 1978, opinion, the American Law Division of the Library of Congress, neither legal provision of the two statutes relied upon by Treasury and the Fed explicitly prohibit or limit Congress' access to information collected under those acts.

(i) Congress is not deemed to have waived by implication its constitutional access rights in the absence of a clear indication to the contrary.

(ii) Statutory restrictions meant to prevent public disclosure are not, in the absence of explicit provisions, applicable to or binding on Congress.

(b) There has been a pattern of Federal agency withholding of such data. It was withheld from the House Science and Technology Subcommittee during the summer of 1978, in conjunction with Treasury-initiated consultations with the Saudi Government. It was previously withheld from a Senate Foreign Relations Subcommittee in 1975, at the request of both the Saudi Government and U.S. banks.

52. Congress needs the country-by-country data to examine the serious inadequacy of the Federal data collection efforts in monitoring foreign portfolio investment. The U.S. Government's differing estimates of Iranian investments and assets in the United States and in U.S. banks abroad (varying from approximately $6 billion to $8 billion or more), and the uncertainty of these estimates make congressional oversight of these data collection efforts absolutely imperative.

53. (a) BEA's refusal to share with Congress OPEC country-by-country FDI investment data and all other data it collects under the 1976 Act constitutes a violation of Congress' constitutional rights of access to information in the executive branch, for the reasons stated above.

VIII. Operations of Federal Agencies in Reporting on Foreign Investment

A. Confidentiality of OPEC Countries' Portfolio Investments in the United States

The Treasury Department maintains, but seeks to conceal, arrangements with the major oil producing countries of OPEC, whereby the amount of their U.S. investments will not be disclosed. An extensive review of documents, provided by the Federal Reserve Board, by the Treasury, and by other agencies reveal beyond question that there is an agreement with Saudi Arabia and Kuwait to keep their U.S.

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[63] Hearings (Part 3), p. 90.
[64] Ibid., p. 691.
[65] Ibid., p. 91.

assets secret by publishing OPEC country investments in general regional categories,[86] such as "Other Asia" and "Other Africa." This policy of nondisclosure has been applied so that Federal agencies or groups needing information about these countries' assets are regularly denied it. Further, on several occasions Treasury has refused to provide to committees of Congress OPEC investment data, in derogation of Congress' constitutional rights of access to executive branch information.

Unsurprisingly, the OPEC countries with the largest surpluses had the business acumen to recognize the leverage they possessed to obtain special advantages in investment markets found in the United States, which also depended significantly on their oil exports. They pressed for special preferential treatment, and it appears that those pressures were not resisted on the U.S. side. Treasury's claim that OPEC investments have not been given special advantages is false.[87]

1. Secret agreement and arrangement with Saudi Arabia and Kuwait

The United States Government entered into rather specific, explicit agreements with these OPEC governments designed to attract their investments by the promise of special treatment, including maintaining the confidentiality of their U.S. investments.[88]

The existence of an agreement is indisputable. In March 1979, auditors from the General Accounting Office interviewed former Treasury Secretary Simon and reported the conversation to the Commerce, Consumer, and Monetary Affairs Subcommittee as follows:

> Mr. Simon discussed negotiations with the Saudis held in 1974 for the purchase of U.S. securities. The fear was that the Saudis would have bought securities from the United States when they felt like it. In order to bring more order to this purchasing system, and because the United States wanted the investment, the Saudis were asked to purchase large amounts of securities. A separate facility, or add-in, was set up to handle the sales. Mr. Simon stressed that if others had wanted such a deal, the United States would have offered it to other foreign governments as well.
>
> In exchange for these security purchases, the United States assured the Saudis confidentiality in reporting data on them by region. According to Mr. Simon, "this regional reporting was the only way in which Saudi Arabia would agree to the deal for add-ons." At no time was Saudi Arabia given securities at preferential rates or ones that were unmarketable.[89]

The specific arrangement with Saudi Arabia assuring confidentiality of OPEC assets was explained to the Secretary of State in a February 1975 memorandum from Under Secretary of the Treasury Jack Bennett. It included a system, through the Federal Reserve Bank of New York, whereby Saudi purchases of U.S. Treasury securities could

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[86] Most of the documents involved are found in Hearings (Part 5), pp. 137–248.
[87] Ibid., pp. 147–159.
[88] Hearings (Part 2), pp. 249–252.
[89] Ibid., p. 80.

be handled outside the regular market, but at prices determined by the regular auction. In effect, the Saudi Government would reserve Treasury securities before they were offered for sale.[90]

The end of that memo contains the U.S. obligation:

> *The sine-qua-non for the Saudis in this arrangement is confidentiality and we have assured them that we will do everything in our power to comply with their desires.*[91] (Emphasis added.)

Accordingly, there can be no doubt that an agreement did exist which covered all Saudi U.S. assets, not just government securities, and which is still being carried out by this administration.

The real rationale underlying Treasury's objective of concealment was offered in the form of "talking points" to Assistant Secretary Bergsten in an undated internal memorandum written by his deputy, F. Lisle Widman. The memo states:

> 7. We believe it is essential that we continue not to release such data. Many foreign governments, including those in the Middle East, consider this to be a sensitive, private matter. Some of the Middle East governments have told us frankly that should information on their financial position (sic) be released, they would consider this to be a most serious breach of confidence, requiring changes in their investment policies in favor of countries which are able to be discrete. Such action, apart from legal considerations, could, therefore, result in depriving the U.S. capital market of an important source of funds and lead to an increase in the cost of funds to the U.S. for external financing of our current account deficit.[92]

The net effect, Mr. Widman goes on to explain, was that beginning in 1974 Treasury changed its disclosure policy to lump all OPEC investments together in reporting worldwide investment figures. This was considered necessary "to respect the confidentiality of government holdings."[93]

Along with Saudi Arabia, Kuwait's special standing with the Treasury was noted in a September 1975[94] memorandum to Under Secretary Yeo from Assistant Treasury Secretaries Cooper and Parsky. A questionnaire had been sent by the Senate Subcommittee on Multinational Corporations to 36 major U.S. banks asking for, among other things, a country breakdown of bank deposits from 22 countries, primarily OPEC members. The banks were thrown into turmoil, and the memorandum explained the "current status" of the situation:

> There are two basic stumbling blocks: First, the banks do not want to divulge their individual portfolios for competitive reasons. Secondly they do not even as a group want to divulge the total holdings of certain countries such as Saudi Arabia and Kuwait because of the sensitivity of these countries. (The published Treasury data lumps the Middle East oil producing countries' bank holdings into one number.)

[90] Ibid., pp. 77–78.
[91] Ibid.
[92] Ibid., p. 74.
[93] Ibid., p. 76.
[94] Ibid., pp. 77–78.

> The Saudis and Kuwaitis expressed alarm over the possible disclosure of their deposits when they were here last week, and Kuwaiti Minister of Finance Atiqui told us—and told Senator Percy—that Kuwait would definitely pull its funds out of U.S. banks if its position were revealed as demanded by the subcommittee.[95]

As the memorandum mentions parenthetically, Treasury was already following a practice of masking OPEC country data, in response to those concerns. This practice of aggregation goes back to at least 1974.

In its formal report, dated June 11, 1979, the GAO described the Treasury's reporting practices more fully, using a somewhat skeptical tone in discussing the reasons Treasury gave for concealing investments by way of aggregation:

> Investments of individual OPEC members are only partially identified in published U.S. Government data. Breakdowns of the amount of investment, whether portfolio or direct, are usually given for Ecuador, Indonesia, and Venezuela. However, all other OPEC countries—notably the Arab OPEC countries and Iran—are reported in some aggregate form, i.e., as "African oil exporting countries," "Asian oil exporting countries," "Other African," "Other Asia," or Middle East." . . .
>
> In the case of the Asian and African oil exporting countries, the major investors in the United States tend to be the government themselves. Therefore, breaking investment figures down by country would, according to U.S. Government officials, reveal individual investors and violate the confidentiality pledged to reporters. Yet Treasury and Commerce do report investments of individual Communist countries—where the major investor is presumably the government, acting perhaps through several entities.
>
> Treasury Department officials cited many of the same reasons for aggregating information on OPEC countries' holdings in the United States and stressed the need to preserve the confidentiality of individual investors' accounts.[96]

Documents reviewed by the subcommittee reveal parallel fears and desires for secrecy on the part of the Federal Reserve. The Fed's position arose out of concerns expressed by member banks, which were interviewed by Fed representatives soon after the banks' receipt of the Senate subcommittee questionnaire.[97] As the staff of the Fed summarized the bankers' concerns:

> The key issues that separate the subcommittee and the banks are: (1) access by the subcommittee's staff to raw data, (2) aggregation by country, particularly anything that in any way identified Saudia Arabia, (3) aggregation by banks, and (4) timing, as the subcommittee wants the data assembled and

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[95] Hearings (Part 5), pp. 160–161.
[96] Report by the Comptroller General of the United States, "Are OPEC Financial Holdings a Danger to U.S. Banks or the Economy?" June 11, 1979, pp. 2–4.
[97] Hearings (Part 5), pp. 174–188.

processed quickly and the banks want time to collect the data. The banks are prepared to resist strongly and some believe there is enough division on the subcommittee that it would not issue subpoenas if the banks refused to respond.[98]

2. Reasons Treasury and the Fed refuse to publish OPEC data or disclose it to Congress

The Treasury and the Fed attempt to justify their apparent lack of regard for the information needs of the U.S. Congress, executive branch officials, and the American public on the basis of a legal argument to the effect that they are precluded from making revelations to the public, and to Congress as well, by the terms of the International Investment Survey Act of 1976, 22 U.S.C., Secs. 3101, *et seq.* (the "Survey Act") and the Bretton Woods Agreement Act, 22 U.S.C., Secs. 286, *et seq.* (the "Bretton Woods Act"). The Treasury's legal position is completely set forth in a memorandum for Assistant Secretary Bergsten, dated October 13, 1978, more than 3 years after the expressions of policy discussed above.[99] Essentially the same reasoning was advanced again before the subcommittee during Assistant Secretary Bergsten's testimony of July 18, 1979.[1]

Both acts relied on by Treasury contain provisions limiting disclosure of information gathered pursuant to their authority. These provisions generally apply to disclosure to the public. The pertinent provisions, viewed in a vacuum, do not specifically address the question of whether Congress may also be excluded from access. The Bretton Woods Act, 22 U.S.C. 286f, states:

> [I]t shall be unlawful for any officers or employees of the Government, or for any advisor or consultant to the Government, to disclose, otherwise than in the course of official duty, any information obtained under this section or to use any such information for his personal benefit.

The 1976 Act, 22 U.S.C.A. 3104(c), states:

> Access to information obtained under subsection (b)(2) of this section shall be available only to officials or employees designated to perform functions under this chapter. . . .

The Treasury's legal argument is a smokescreen to obscure its real reasons for hiding OPEC investment data. Treasury's real rationale can be observed from the following: on November 15, 1978, one month after Treasury's counsel wrote the legal opinion previously discussed, Secretary of the Treasury Blumenthal wrote a letter to CIA Director Turner in which he strongly expressed the need for secrecy concerning the investments of the "Middle East Oil Exporting Group" in particular. The letter states that these countries had:

> . . . specifically requested that information we have on their investments in the United States or other countries be treated highly confidentially. *For this reason*, we have declined to provide this material either to the Congress or the public, except in highly aggregative (sic) form.[2]

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[98] Ibid., p. 175.
[99] Ibid., pp. 206–215.
[1] Hearings (Part 2), p. 212.
[2] Hearings (Part 5), pp. 229–230.

Blumenthal in no way mentioned any legal requirement to maintain these confidences.

In August 1978 Assistant Secretary Bergsten told Secretary Blumenthal in a memorandum that the State Department has withheld from Congressman Scheuer (NY) detailed information on Saudi assets in the U.S. "largely due to Treasury's insistence that the confidentiality of this information be maintained." The memo went on to say that the "*stated basis* for withholding this data" was that the statutes cited above "prevent its release to the Congress." [3] (Emphasis added.)

The same memorandum ends by suggesting how the Secretary might reassure the Saudis of Treasury's solicitude for their secrets and its ability to hold out against the Congress and the public:

> We believe that we will be able to maintain the confidentiality of the detailed Saudi Arabian investment data which we hold but given current pressures, there is some risk that we will not be successful. Perhaps the Saudis should be told of current developments concerning this issue.
>
> In your discussions with Saudi Arabian officials you may wish to draw on the following points:
>
>> In recent months we have received a number of requests from Congress, the press and private citizens for information on the investments of your country in the U.S.
>>
>> We have resisted the disclosure of this information to all requestors on both legal and policy grounds. To date, we have been successful in these efforts.
>>
>> A basic principle of this Administration's policy on inward foreign investment is to accord privacy to individual investor decisions.
>>
>> We appreciate your continued use of U.S. capital markets and will continue to the maximum extent possible to keep the details of your assets in the U.S. confidentiality.[4] (Emphasis added.)

The lack of an operative legal requirement to withhold can also be deduced from the testimony of Assistant Secretary Bergsten before the subcommittee on July 13, 1979. His prepared statement includes a footnote reading in part:

> The disclosure policy of the Treasury has been applied uniformly in the sense that confidential treatment is available to any investor (1) whose investment could be disclosed, contrary to the Bretton Woods Agreements Act and the Investment Survey Act of 1976, by publication of the individual country data and (2) who wishes to take advantage of it. The Government of Canada has indicated that it has no objection to disclosure of its holdings, which are therefore disclosed. The governments of several OPEC countries have indicated that they would object to disclosure of their holdings, which would in fact occur if data for those indi-

[3] Ibid., p. 199.
[4] Ibid., p. 201.

> vidual countries were reported because official holdings represent such a high share of total country holdings; thus these countries are grouped with several others to avoid disclosure of the holdings of individual investors. No other governments have objected to our long-standing presentation, so we have not felt it necessary to alter our presentation. Any government which did indicate a desire to avoid disclosure of its holdings, where those holdings were found to represent the bulk of the country's total holdings, would receive similar treatment.[5]

If a foreign government, as an investor, is able to have its investments protected from disclosure, it follows logically that Treasury has discretion either to withhold information concerning these investments or to publish the information. Yet the Acts relied upon are mandatory and use the word "shall." Treasury's application of these provisions in a discretionary manner shows that even it does not really believe that they require nondisclosure in this situation.

Importantly, the acts do not expressly limit disclosure to Congress, and it is the studied opinion of both the American Law Division of the Library of Congress and the General Counsel of the General Accounting Office (GAO) that Congress can be denied information only when it has barred itself from access by saying so in a legislative enactment.[6]

The American Law Division opinion, dated July 19, 1979, concludes:

> The power to inquire and seek information pursuant to oversight and legislative functions is an inherent constitutional power of the Congress. Restrictions meant to prevent public disclosure are not, in the absence of explicit provision otherwise, applicable to the Congress and it must be presumed that a congresssional committee will act responsibly with respect to sensitive information. In the face of constitutionally based powers to obtain information, statutes which do not explicitly bar congressional access—especially statutes such as 22 U.S.C. 286f and 3104(c) with demonstrable legislative intent to the contrary—cannot be construed to be binding on Congress.[7]

The GAO General Counsel's opinion concluded with the following:

> . . . the fact that this information is considered confidential does not, in our view, affect Congress' access to such information, but is designed to restrict public disclosure.[8]

As discussed in the American Law Division opinion, Treasury's refusal to furnish to Congress OPEC country investment data is in violation of Congress' right to access of information in the executive branch. Congress has the constitutional duty to legislate and oversee agency operations and to inquire and seek information essential to

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[5] Hearings (Part 2), p. 214.
[6] The American Law Division legal opinion is reproduced in Hearings (Part 2), pp. 60–70. The GAO view is contained in the last paragraph of its letter opinion, reproduced in Hearings (Part 5), pp. 216–221.
[7] Hearings (Part 2), p. 69.
[8] Hearings (Part 5), p. 221.

the discharge of those duties. In withholding data, Treasury derogates Congress' constitutional prerogative. This is particularly serious because one of the purposes of the 1976 Act was to provide Congress with accurate and comprehensive information.[9]

It also derogates the public's right to know in a manner inconsistent with the basic policy underlying the International Investment Survey Act of 1976. The General Accounting Office has criticized Treasury's justification for concealing OPEC country-by-country data. In a recent report GAO stated:

> [Treasury takes the position that it] cannot reveal totals of certain countries because they would reveal the affairs of certain individual foreign investors. We do not agree with these reasons. Stated in this manner, Treasury's decision appears to be one of protecting the privacy of individual human beings. In fact, they are withholding information concerning massive transactions of official government monetary institutions.[10]

3. Treasury's Limitations on CIA and FED Usage of OPEC Investment Data and Its Refusal to Share Such Data With Other Federal Agencies

As the agency which collects the data, Treasury greatly restricts the flow of OPEC investment information within the executive branch, among agencies with obvious needs to know. Treasury has restricted the CIA and Fed usage of this data. It has also refused to share the data with the Commerce Department or a high level *ad hoc* committee concerned with withdrawal of Iranian assets.

When differences of opinion have arisen between Treasury and other agencies, or when other agencies have erred in the direction of candor, Treasury's position appears always to have carried the day. The other agencies have been willing to subordinate their position to that of Treasury's and generally avoid "trespassing" on its forbidden territory of investment policy and the confidential treatment of foreign investor data.

A noteworthy example can be seen in Treasury's reaction to what it saw as an indiscretion on the part of the CIA. In September 1978, the Dow Jones ticker carried a statement attributed to "intelligence sources" that the Soviets were abandoning the dollar for Deutsche marks. A check revealed it was based on CIA information which, although publicly available, should not have been attributed to CIA sources. At about the same time, Treasury learned that there were revelations about Saudi foreign assets, based on CIA supplied information, in the draft of an unclassified letter the Department of State planned to send to Congressman Scheuer, Chairman of a House Science and Technology Subcommittee.[11]

State had told the Dow Jones reporter not to attribute what he wrote and the information it gave him was not classified. State was the guilty agency in misusing the classified information it had re-

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[9] Hearings (Part 2), p. 67.

[10] Comptroller General's report to Congress, "Changes Needed to Improve Government's Knowledge of OPEC Financial Influence in the United States," December 10, 1979, pp. 23–24.

[11] Hearings (Part 5), pp. 222–235.

ceived from the CIA. It was not possible to fault the CIA for the revelation. Still, the incident gave Treasury executives an opportunity to vent their general concerns about the CIA's habit of being responsive to congressional inquiries on foreign investment matters and its "continued circulation . . . of detailed statistics on dollar holdings of individual countries" among Government agencies. Despite the security classification the CIA placed on these statistics, they were more likely to be released within the government.[12]

A September 14, 1978, internal Treasury memo described for Under Secretary of the Treasury Solomon how "our intervention . . . prevented [Saudi dollar holdings data] from being transmitted to Congress." It went on:

> Foster Collins called the CIA people this morning and got them to agree to refer such questions to Treasury in the future. Nevertheless, you may want to consider whether you or Secretary Blumenthal should explain the sensitivity of this subject to Admiral Turner on some appropriate occasion.[13]

Subsequently, Secretary Blumenthal sent a letter to CIA Director Turner reminding him that data from Treasury and Commerce was not to be re-released by the CIA, and also asking that Treasury be given the opportunity to concur in CIA dissemination of investment data to Congress, even if the information were developed from CIA's own sources.[14] Admiral Turner agreed to consult before responding "to congressional requests on OPEC foreign asset questions," despite his stated concerns about an implicit conflict with the CIA's independent responsibilities to disseminate "intelligence within the government" and its obligations to its oversight committees, under the terms of Executive Order 12036. In any event, Admiral Turner was apparently willing to set aside CIA's duty under the executive order, insofar as investment data were involved. He advised Secretary Blumenthal:

> Nevertheless, recognizing the serious adverse consequences that unauthorized disclosure could have, I have instructed OER to consult with your Department before providing substantive requests on OPEC foreign asset questions.[15]

The Treasury's tight reign over its sister agencies is also revealed in a memorandum the subcommittee reviewed, describing Treasury's posture toward the Iran Consultative Group.[16] The group was set up to keep track of the developing Iranian crisis in late 1979, including possible withdrawal of Iranian assets, and included representatives from State, Defense, Energy, Treasury, the CIA, the National Security Council (NSC) and the International Communication Agency (ICA). The memorandum to Under Secretary Solomon from Deputy Assistant Secretaries Junz and Widman (undated) states:

> As is always the case in such groups, Treasury was asked for an analysis of the consequences for the dollar if an Iranian government acted irresponsibly and "pulled its money

[12] Ibid., pp. 225–35.
[13] Ibid., p. 225.
[14] Ibid., pp. 229–30.
[15] Ibid., p. 233.
[16] Ibid., p. 238.

> out of dollars." A further request was made for an analysis of the vulnerability of the U.S. banking system to such actions as well as to an Iranian failure to repay outstanding loans. . . .
>
> We hope [a general statement] will be satisfactory as *we cannot supply data on bank claims and liabilities nor would it be wise to supply more than a general statement* on the foreign exchange markets. We believe it may be necessary for you to call Newsom to indicate that this forum is not the one for consideration of these matters. *A call to Henry Owen also might be in order since Rud Poats was the one pressing the issue in the subgroup.*[17] (Emphasis added.)

It should be noted that Rud Poats is a National Security Council staffer and that Henry Owen was his superior. It is inconceivable that Treasury would deny Iranian investment data to a high level group investigating the consequences of the withdrawal of that data, but it did.

In November 1978, the Department of Commerce, Bureau of Economic Analysis (BEA), drafted a memorandum which explained its need for OPEC country investment data and why Treasury's policy of concealment hindered its mission:

> This lack of country detail *hinders* the work of the Balance of Payments Division in compiling, presenting, and analyzing these data as part of the international transactions accounts and investment position of the United States.
>
> Access to detailed information would *be very helpful* in uncovering statistical deficiencies in the double-entry bookkeeping system used in balance of payments accounting. This problem is *especially troublesome* with respect to large transactions of individual oil-exporting countries, which require careful examination to ascertain that the proper credit and/or debit entries are included. Also, the analysis of such issues as borrowing by Iran, the use of international reserves by Saudi Arabia and Kuwait, and the international financial role played by Bahrain, would be facilitated by the provision of individual country data to us by Treasury.[18] (Emphasis added.)

The memorandum was never sent because Treasury staff had informally advised BEA's staff that Treasury would not share the data, even under protection for confidentiality. Previously, GAO had found the same situation:

> Treasury believes that all U.S. Government agencies which have a need for foreign investment data have access to such data. This is not the case. Department of Commerce officials have made several requests for OPEC portfolio investment data by country to Treasury officials; these requests have been refused.[19]

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[17] Ibid.

[18] Ibid., p. 239.

[19] Comptroller General's Report to Congress, "Changes Needed to Improve Government's Knowledge of OPEC Financial Influence in the United States," December 19, 1979, p. 39.

Even as to the FED, which has obtained the OPEC country-by-country data, Treasury has placed strict conditions on its use. These conditions effectively bar FED officials and FED Governors from access to such data. As an internal New York Federal document states:

> *Note:* The data in this memorandum were compiled from Treasury Foreign Exchange Reports and from information supplied by the Foreign Operations Division of this Bank's Foreign Department. The Treasury may be extremely sensitive to these data being made available even to high officials of this Bank or to members of the Board of Governors since such access is not explicitly included in the existing access "agreement" with the Treasury. The Treasury is particularly sensitive to the release of data that are highly concentrated at one respondent, as are some of the figures in this report.[20]

B. CONFIDENTIALITY OF OPEC COUNTRY AND OTHER COUNTRY FOREIGN DIRECT INVESTMENTS IN THE U.S.

BEA advised the subcommittee that it does not disclose certain OPEC direct investments, as well as other investments, because of its confidentiality rules and not because of any bilateral agreements with OPEC countries.

BEA's rules are based on its broad interpretation of Section 5(c) of the 1976 Act, which states that no information collected under the Act may be published or released:

> in a manner that the person who furnished the information can be specifically identified except as provided in this section.

If two individual investors (which includes business entities and government institutions, as well as individual persons) own 90 percent or more of all investments in a particular industry sector or from one country, or one individual owns 80 percent or more of the same, then BEA will not reveal the dollar figures. It will further suppress other data. For example, as of June 1979, there was one direct investment from Abu Dhabi. In order to suppress the amount of that investment, BEA suppressed the value of the nine direct investments from Saudi Arabia.[21]

Commerce's Chief Economist explained to the Subcommittee the rationale for applying confidentiality in this manner:

> That is in order to comply with the legal requirement that we not disclose information which could identify the amount invested by a specific individual.[22]

The Chief Economist then confirmed that the BEA rules are predicated on the fear that someone who "digs" deeply would be able to find out the identity of the investor, when there were only one or two investors from one country or within a particular industry subsector for that country.

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[20] March 9, 1977, Office Memo (NYFED), from T. J. Giletti, Balance of Payments Division, to Mr. Meek, Subject: Saudi Portfolio Investments in the United States.
[21] Hearings (Part 2), p. 323.
[22] Ibid., p. 321.

BEA has extended its confidentiality rules beyond the meaning of the 1976 Act. As long as BEA publishes data which does not *per se* specifically identify the entity or person furnishing the amount, the 1976 Act is not violated. Not publishing dollar amounts of investments is irrelevant for that purpose, because the Act protects persons not the amounts of investment. That others may discover the identity of an investor based on their own research efforts, even if they rely in part on BEA data, should be of no consequence to BEA because that situation is not covered by the Act.

This misinterpretation and misapplication of Section 5(c) has resulted in BEA's concealment of substantial amounts of FDI data, especially by industry subsector, both for OPEC countries and for other countries.

C. BEA REPORTING OF FDI DATA GENERALLY

I

Every August in its regular monthly publication, Survey of Current Business, BEA publishes its FDI data for the previous year. The data published in this article is very sparse.[23]

First, BEA's figures on FDI are broken down by only five industry sector categories: petroleum, manufacturing, trade, insurance, and other. No further breakdowns are provided, even though there is a heavy concentration of foreign investment in a certain subsector, such as chemicals and pharmaceuticals. In 1976, the Commerce Department observed the problem with these general categories:

> Foreign direct investment occurs in almost all major segments of U.S. manufacturing and in several parts of the retail trade. The range is broad: from agricultural chemicals, textile machinery, and medical instruments to thread, zippers, ballpoint pens, supermarkets, and department stores. It is particularly strong in the food processing, metals fabricating, chemical, and machinery sectors (as well as in petroleum refining, covered primarily in another section).
>
> Foreign direct investment in the U.S. manufacturing accounts for no more than 6 percent of the total output of any two-digit SIC [Standard Industrial Classification] industry. The analysis here, however, focuses primarily on industries at the 4-digit level. At that level, the foreign presence is more pronounced, ranging up to about 30 percent. In the case of a few highly specialized products, mostly at the 7-digit level, the market share of foreign-owned firms is as high as 50 percent.[24]

The lack of detailed industry subsector information, as already noted, makes it difficult for the Energy Department, OFIUS, and others, to report on and analyze FDI.

Next, for each of these five industry sectors, BEA publishes aggregate data only for Canada, Europe (excluding the United Kingdom),

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[23] The most current BEA article was published in August 1979 and is found in Hearings (Part 3), p. 160 et seq.

[24] Report to the Congress: Foreign Direct Investment in the United States, Department of Commerce, April 1976, Vol. 1, pp. 63–64.

the United Kingdom, Japan, and other. The "other" category includes all countries in Africa, South America, and the rest of the world; it includes all OPEC countries.

For all the industry sectors together, BEA publishes aggregate data for only six European nations, Japan, and Canada, and other. Once again, the "other" encompasses most of the world and includes all OPEC countries.

While previously-discussed deficiencies in BEA's data collection (including lack of investment information on the country of origin, on assets, and on products and services correlated to a firm's activities) contribute to this poor record of reporting, it is clear that BEA could report much more than it does.

This greater detail, as noted in the HUD study on FDI, is absolutely necessary to identify the extent and nature of FDI.[25]

II

BEA's 1977 data, derived from its 1977 BE-15 survey, conducted at the very end of 1978, has not yet been published. In April 1979, BEA advised the Senate Committee on Commerce, Science, and Transportation, that this data would be published in August 1979.[26] BEA still has not published it because of other BEA priorities and delays. BEA has recently advised the subcommittee that the data should be published in the July 1980 Survey of Current Business.

D. REPORTING OF FDI DATA BY OTHER FEDERAL AGENCIES

Federal agencies have a poor history of publishing FDI data. The Census Bureau did not publish "Selected Characteristics of Foreign-Owned U.S. Firms: 1975–1976" until November 1978, one year late.[27] The Department of Energy did not release its 1978 Report to Congress until late 1979. Even though there would have been time to include 1978 data on FDI in the energy sector, DOE unjustifiably failed to include such data.[28]

In 1977, the GAO recommended that the Director of OMB:

> develop a plan, with the assistance of the independent regulatory agencies and other agencies monitoring foreign investments in national interest areas, (1) for those agencies to assess the reliability of the foreign investment information already being received and (2) to make such information periodically available in a uniform summary for each regulated industry as a report to Congress.[29]

OMB's Director responded to GAO and stated that, since the President had delegated all of his responsibilities under the 1976 Act to OMB, OMB would pay close attention to the recommendation in carrying out these tasks. All of OMB's responsibilities in this area have

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[25] Hearings (Part 3), p. 241.
[26] Hearings before the Committee on Commerce, Science, and Transportation, U.S. Senate. "Authorize Appropriations Under the International Investment Survey Act of 1976." Serial No. 96–16, April 11, 1979, p. 14.
[27] Hearings (Part 5), p. 32.
[28] Ibid., p. 33.
[29] Comptroller General's Report to Congress, "Controlling Foreign Investment In National Interest Sectors of the U.S. Economy," October 7, 1977, p. 38.

FEB 5 1975

MEMORANDUM TO THE SECRETARY OF STATE

Subject: Special Arrangements for Purchase of U.S. Government Securities by the Saudi Arabian Government

SUMMARY

In recent months we have had extensive discussions with officials of the Saudi Arabian Monetary Agency (SAMA) concerning investments in U.S. Government Securities. In December we reached an understanding whereby SAMA will purchase new issues of marketable U.S. Treasury obligations with a maturity of one year or more through a special arrangement involving the Federal Reserve Bank of New York, as agent. Purchases under this arrangement over the next six months are expected to be approximately $2.5 billion. This amount will be in addition to any other acquisitions of Treasury or United States agency obligations made by the Saudis through other channels or at shorter maturities. It should be emphasized that this arrangement does not involve issues specially designed for the Saudis, but rather constitutes special purchases of marketable securities.

THE ARRANGEMENT

In December, 1974, in Jidda, the Treasury reached agreement with SAMA to establish a new relationship through the Federal Reserve Bank of New York with the Treasury borrowing operation. Under this arrangement SAMA will purchase new U.S. Treasury securities with maturities of at least one year. When announcement of a Treasury offering is made, the Federal Reserve will query SAMA immediately as to its interest in purchasing additional amounts of the same issue at the average price of the auction. Should SAMA desire to acquire any such securities, it will inform the Federal Reserve Bank of its interest prior to the auction. The mechanics of payment, deposit of securities, etc., will be handled between SAMA and the Federal Reserve. Should SAMA wish to sell these securities prior to maturity, it will offer Treasury for two days the opportunity to repurchase the securities at the then prevailing market price. While the current arrangement is limited to new marketable securities,

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in the future SAMA may request that we consider issuing on a similar basis an additional issue of securities of a type already outstanding and non-marketable securities of a short-term duration specially tailored to fit a short-term investment need of SAMA.

The principal advantage to the Saudis of this arrangement is that it will avoid the disruption to the market occasioned by large security purchases or sales on their part. It should be emphasized that the purchases are at the auction average. Thus we are giving the Saudis no interest rate advantage compared with other lenders.

The amount of special purchases contemplated is approximately [redacted] over the next six months. We expect the Saudis to continue in addition to purchase short-term Treasury securities through normal market procedures as well as to purchase securities of sponsored U.S. agencies such as the Federal National Mortgage Association. At present outstanding Saudi holdings of U.S. Government Securities is [redacted] of which [redacted] is in the form of notes purchased under the special arrangement. Another [redacted] of notes under the special arrangement have been purchased for delivery on February 18.

The sine-qua-non for the Saudis in this arrangement is confidentiality and we have assured them that we will do everything in our power to comply with their desires.

/S/ Jack F. Bennett

Jack F. Bennett

With the removal of the deleted part of this document, this document is unclassified.

MSC 14 11/70

FEDERAL RESERVE BANK
OF NEW YORK

S

OFFICE CORRESPONDENCE

DATE March 9, 1977

TO Mr. Meek

SUBJECT Saudi Portfolio Investments in the United States

FROM T. J. Giletti
Balance of Payments Division

Copies to: Mr. Fousek and Mrs. Ehrlich

STRICTLY CONFIDENTIAL--(TREASURY/F.R.)

> Note: The data in this memorandum were compiled from Treasury Foreign Exchange Reports and from information supplied by the Foreign Operations Division of this Bank's Foreign Department. The Treasury may be extremely sensitive to these data being made available even to high officials of this Bank or to members of the Board of Governors since such access is not explicitly included in the existing access "agreement" with the Treasury. The Treasury is particularly sensitive to the release of data that are highly concentrated at one respondent, as are some of the figures in this report.

This correspondence written at your request reviews the disposition of portfolio investments in the United States by the Saudi Arabian Monetary Authority. The attached statistical appendix includes tables showing the levels of and changes in Saudi holdings for total official, FRBNY and "street".

SAMA's investments in the United States stood at slightly more than at year-end 1976, having risen from year-end 1975 (see Table 1). Saudi Officials' holdings at the end of 1976 were about 55 percent of OPEC total holdings and about 62 percent of OPEC Official's investments. Total Saudi international reserves were in December, according to the IMF; of this total percent was held in the United States. Saudi accounts at FRBNY stood at at the end of December 1976, having increased last year (See Table 2). SAMA held percent of its U.S. investments at this Bank at the end of 1976, compared with percent at year-end 1975.

~~SECRET~~

35

Saudi Arabia: Foreign Assets

Background

Worldwide Saudi assets at end-September, 1978 are estimated at about $63.5 billion, up slightly from about $62 billion at end-1977. About 78-80 percent of these assets are dollar-denominated. For some time, the Saudi's have pursued a very modest diversification program, converting small amounts of dollars to other currencies. In recent months, appreciation of other currencies relative to the dollar--in conjunction with the modest currency diversification program and disbursements under prior year aid commitments--may have pushed the proportion of their assets denominated in dollars below 80%.

The geographic distribution of Saudi foreign assets is estimated as $ in the U.S., in other developed countries in developing countries and in international financial institutions. About allotted to other developed countries is in the form of foreign currency deposits with banks in the Euromarket and offshore financial centers. Claims on the governments and private non-banking sectors of other developed countries amount to roughly [redacted] percent of total assets.

Total Saudi assets held in the United States/ and foreign branches of U.S. banks amount to an estimated as of end-August. Their financial assets in the U.S. total consisting of in government securities and billion of claims on the private sector. Contrary to prior years, net Saudi investments in the U.S. in 1978 have been in corporate securities and bank deposits. Holdings of U.S. Treasury securities have decreased from at end-1977 to in August. Saudi non-financial assets in the U.S. consist of prepayments on U.S. exports of goods and services, largely military procurement (table attached). On net, the Saudi's have drawn-down assets in the U.S., in 1978, by

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Saudi Arabia: Net Placements in the United States and in Foreign Branches of U.S. Banks
($, billions; (+) inflow/(-) outflow)

	Cumulative Total	1974	1975	1976	1977	1978 Year-to-date	1978 QI	1978 QII	1978 Jul.-Aug.
Banking and Portfolio securities									
Treasury securities									
Bills									
Bonds and notes									
Government agency securities									
Corporate securities									
Stocks									
Bonds									
Bank reported liabilities									
subtotal, banking and portfolio									
Other Assets									
Deposits with U.S.G. agencies 1/									
U.S. non-bank liabilities 1/									
subtotal, other assets									
Total: Assets in U.S.									
Liabilities of U.S. bank foreign branches 1/									
Grand total									

CLASSIFIED BY Daniel H. Brill
EXEMPT FROM GENERAL DECLASSIFICATION
SCHEDULE OF EXECUTIVE ORDER 11652
EXEMPTION CATEGORY 5B (3)
AUTOMATICALLY DECLASSIFIED ON
Impossible to Determine

Source: Treasury International Capital Movements reports, Department of Commerce BIP reports
Federal Reserve 502 reports

* less than $50 million
1/ as of June 30, 1978
NA not available

Office of International Banking
and Portfolio Investment
October 25, 1978

D. U.S. GOVERNMENT CONSIDERATION OF OPEC COUNTRY DEMANDS FOR INFLATION-INDEXED BONDS

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

April 21, 1976

MEMORANDUM FOR STEPHEN W. BOSWORTH

Subject: NSSM 237: The Issue of "Specials"

We have asked the Treasury Department Office of the General Counsel for an opinion whether the U.S. Treasury can, from a legal standpoint, issue U.S. Government bonds with the principal linked to some price index (either U.S. or foreign) which are specially issued to a particular purchaser and are not offered generally to the public.

That office has advised against the issuance of government securities with indexing clauses in light of an October 1975 decision of the Tennessee Supreme Court (Aztec Properties, Inc., v. Union Planters National Bank, 530 S.W. 2d 756, Oct. 27, 1975). The Tennessee Supreme Court held that the 1933 Gold Clause Joint Resolution (3. U.S.C. 463) renders unenforceable a promissory note for "indexed principal". This decision, while not binding on Federal courts (where action concerning such bonds would have to be brought) may still raise questions pertaining to the enforceability of any indexing clauses included in United States Government securities. In addition, the expenditure of government funds to meet "indexed principal" could be considered a direct violation of 31 U.S.C. 733c which prohibits payment upon U.S. Government securities "except on an equal and uniform dollar for dollar basis". These legal uncertainties militate against the issuance of indexed U.S. Government bonds.

Moreover, as a policy matter, the Treasury, for some time, has opposed the issuance of any indexed bond. In response to a request in 1969 by the Honorable Wilbur D. Mills, then Chairman of the House Ways and Means committee, for Treasury views on a proposal for indexed "cost-of-living savings bonds", it was stated that "proposals of this nature have been received from time to time and have consistently been opposed by the Department". Among the reasons given for Departmental opposition were

-- such bonds would add to the dynamic process of inflation;

-- such bonds would raise equity questions by discriminating in favor of their holders at the expense of all taxpayers and particularly against low income groups who are unable to hedge against inflation through these bonds or otherwise;

-- such bonds would run against our debt management responsibility and sound principles of finance causing the Government to commit itself to liabilities of an indeterminate amount.

The issuance of special indexed bonds to foreign governments, in addition to expanding the equity difficulties to include foreign investors, also runs counter to current U.S. Government policy on foreign investment. The U.S. position regarding foreign investment is to support the free flow of capital across international boundaries. Furthermore, if this flow is to work to the maximum benefit of all countries, it must remain, as far as possible, undistorted by artifical impediments and incentives. This policy is founded on the premise that the free market should be relied upon as the most efficient means of determining the international allocation and use of capital. Hence, we have continually stated in the OECD that we would take no special discriminatory action that would attract OPEC funds to the U.S.

Thus, both from a policy and legal point of view, Treasury cannot consider the issuance of specially indexed bonds as a viable U.S. Government policy option, and therefore, we are opposed to any language in NSSM 237 which states or in any way suggests the contrary.

Charles Schotta

Charles Schotta
Director
Energy Policy Analysis

Mr. Reed J. Irvine — Saudi Interest in Indexed Bonds.

Alan Lang

According to what Mr. Debs learned from the financial authorities in Saudi Arabia (see telegram from our embassy in Jidda - April 29, 1974), it appears that the Saudis intend to make a major push for a bilateral arrangement with the U.S. Government for investment of their surplus funds in U.S. Government securities. Currently, the Saudis are accumulating surplus funds at the rate of $50-$60 million a day, and are obviously anxious to place them in a secure long-term store of value. Government bonds that are indexed to compensate for inflation and carry an exchange rate guarantee apparently are much on their mind.

The possibility of creating a special payments facility in the form of indexed bonds, whether bilateral or multilateral, has been discussed at various national and international forums, most recently at the investment seminar in Kuwait last February, (see also my paper "The Problem of Investing Surplus Arab Funds"). There are two potential economic benefits that the oil importing countries could derive from the creation of such a facility: it would induce oil exporters to maintain production beyond their immediate import payment needs, and it would help to direct the resulting surpluses into investment channels favorable to the interests of oil importers.

Until the latest doubling of oil prices in January 1974, it had been generally expected that prices would continue rising for years to come, and so would the value of oil left in the ground. The new prices, however, may represent the peak, and given the changing supply-demand relationship in the world oil market, oil prices are now expected to begin declining in the near future. The argument, therefore, is being advanced that it is in the interests of oil exporters to maximize production now, investing the proceeds at some positive rate of return, rather than to keep oil in the ground where it earns no return at all. Consequently, it is said there is no longer any need to provide special guarantees of the surplus funds' value. The oil producers, it is being argued, no longer need any special incentives.

It is not clear, however, that the reason for creating indexed bonds in order to induce adequate oil supplies has been totally invalidated. The OPEC countries, with possible exception of Saudi Arabia, have stated emphatically their intention to maintain present terms of trade for their oil, advancing oil prices, at least proportionately to the rate of inflation. At least for a while, they will have means to achieve their objective. The Saudi's strong interest in indexed investment instruments seems to imply that they too would go along with the OPEC majority. The real rate of return on oil in the ground thus still my be as high as the real rate of return on financial investments.

FILE COPY

May 3, 1974

Mr. Bryant

Reed J. Irvine

Handling Saudi Arabian Investments.

The attached telegrams and the memo from Alex Lang point up the continuing need to give attention to the problem of helping the Saudi Arabians and other oil-rich Arabs find acceptable ways to invest the huge amounts of money that they are now obtaining.

The Saudis are favorably disposed toward us, and I believe that if we show ourselves willing to help them solve what is a very difficult problem we will be more likely to have their cooperation in solving our energy problems in the future. Their problem and their position is unique, and I believe that the solution may well have to be unique. We surely need to give serious consideration to the question of how flexible and imaginative we can be in finding ways of handling their surplus funds in ways that will be attractive to them and practical for us.

It is argued that we cannot devise special instruments for the Arabs, and perhaps this is true, although I am not sure that people would not accept a need to make special arrangements as a price for insuring oil supplies.

However, why not give consideration to the introduction of an instrument that would give all savers protection against inflation? We need not go as far as Brazil and index all bank accounts, but surely we could provide some indexed bonds. There is no reason why they could not be made available to everyone. Savers in this country have been getting a very poor deal during the latest wave of inflation. Attractive savings instruments would be a good anti-inflationary device.

Attachments.

copies to: Mr. Reynolds
Mr. Pizer

RJI:sc
5-3-74

as amounts of surplus funds rise to astronomical levels, it could be ever more difficult for the oil exporters to protect their value against losses through changes in exchange rates. In comparison, being an internationally traded commodity, oil always enjoys an almost total security in this respect. Oil in the ground, furthermore, at least for a while, still appears to be politically more secure form of investment than overseas investments of surplus funds, especially in view of inherent and increasing instability of foreign economies and governments.

Thus, from the point of view of oil exporters (especially exporters with large import demand but limited oil reserves), it may be still advantageous to maintain oil production at levels just sufficient to meet their import-payments needs. It is now the exporters of the type of Iran, Algeria, Venezuela, rather than the exporters of Saudi Arabian type, that may require special incentives to induce them into production expansion.

There is another reason for creation of a special payments facility in the form of indexed bonds. It is to induce the exporters to channel surplus funds into long-term investments in the manner preferable to the importing countries. Indexing as a price of immobilizing a substantial proportion of surplus funds, preventing their potentially destabilizing impact on international and national financial markets and economies, may be worthwhile in itself. It may be a smaller price to pay than to allow the oil exporters to seek to protect the value of their financial assets by playing the market.

The exporters already have sufficient financial power to influence the international financial markets, and this power is likely to expand to an enormous extent in the next few years. Conceivably, they can withhold credit from some countries bringing interest rates, especially on long-term loans, to a level sufficient to compensate for all the disadvantages and risks inherent in financial investments. They may be also in a position to impose upon borrowers terms that would protect their funds from inflation and devaluation losses. The fact that the exporters have so far refrained from using their financial power in ways detrimental to the interests of importers is no guarantee that they will not attempt to do so in the future.

The cost to the OECD countries of giving the oil exporters an exchange rate guarantee by denominating liabilities in SDRs valued in terms of a basket of currencies, would be very close to oil. The cost of indexing any special payments facility, if this is done on a coordinated basis, may also be much lower than doing this on a purely bilateral basis. This is in general a problem of comparing costs and benefits of alternative courses of action: leaving it to the oil exporters to seek to protect the value of their surplus funds by playing the market, or devising a special payments facility which would provide them with such protection.

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

MET

Office Correspondence

Date October 30, 1978

To Mr. Edwin M. Truman

Subject: Indexing OPEC Assets

From Samuel Pizer

It is usually left unclear whether this would apply to: (1) certain present dollar assets in the U.S.; (2) certain present dollar assets held abroad; (3) all present dollar assets anywhere; (4) only future dollar earnings from sales to the United States; any future earnings of any kind; (5) some proportion of any of the above. Nor is it stated what form the indexing would take: a U.S. Government obligation with principal (and interest) tied to, e.g., the SDR basket, a multi-laterally guaranteed investment, etc. Generalized pros and cons may have more or less relevance or significance, depending on what, exactly, the basic proposition is. However:

Pros:

1. Indexing will encourage OPEC countries not to switch from dollars to other currencies, thus supporting the dollar

2. It will encourage them to hold down prices

3. It will encourage them to maintain supply (not entirely a separate issue from (2))

4. It will encourage them to support U.S. political objectives, such as peace in the Middle East

5. If OPEC assets are in the form of a U.S. Government obligation, we would know where the money is and could block it in the event of another embargo.

Cons:

1. Other holders of dollar assets, domestic and foreign, would demand equal treatment. (Some foreign governments outside of OPEC hold far more dollars than any OPEC country.)

2. If done unilaterally by the United States it could be viewed by other countries as an attempt to obtain a special position vis-a-vis OPEC, and to obtain financing that might otherwise go to LDCs or the IMF

3. It would be difficult to give this facility even to all OPEC countries since our relationship to some (notably Saudi Arabia) is far different from our relationship to others (Libya, Iraq)

4. OPEC countries already achieved a sufficient rise in the real price of oil in 1973-74 to compensate for quite a few more years of reduction in the real value of their assets

5. OPEC countries don't have great scope for switching out of dollars in any case, since their avoidance of future loss would be more than offset by the loss they may bring about in the value of their present dollar assets

6. OPEC has protected itself when necessary by raising prices, and will probably continue to do so. Not all OPEC countries can be equally compensated by indexing assets because their asset position are so different. (A collateral pro is that indexation might be divisive for OPEC)

7. We have consistently refused to give Congress any data on holdings of single countries, like Saudi Arabia, in the United States. How could we refuse once we start subsidizing such holdings - which would require Congressional clearance, I would assume

8. If we indexed, but OPEC prices rose anyhow, somebody would have to answer some questions

9. We already exercise considerable influence over Saudi Arabia through other channels far more effective than indexation of some of their assets

10. Unlike some other countries we have given OPEC countries unlimited access to our capital markets, and extend to them the protection of our laws and total freedom of movement. This should be sufficient to encourage them to look to the United States as a long-term haven for their funds without the need for any additional incentive

11. Indexation could be expensive for the taxpayer - how expensive depends on what it is supposed to cover and whether there is an equivalent adjustment of yield on these assets

12. It is inconsistent to support indexation as a device for holding down import prices while supporting domestic price increases as a means of reducing oil demand and increasing domestic output. However, this is not more inconsistent than the general thrust of the price effects of the energy program

13. If the question is the indexation of current earnings, compensation is paid for high rates of inflation in the form of higher

yields on assets acquired; if the question is indexation of compensation of the proceeds of earlier sales of oil that have been invested as depreciating dollar assets - part of this is met by rising yields as short-term debt matures and is rolled over, and the remainder was already compensated for by the extraordinary rise in oil prices in 1973-74

14. Indexation is a one-way street as usually proposed - i.e., it is an option of the investor. A corresponding option for the borrower should also be part of the bargain. Suadi Arabia now has the option of raising prices - we cannot give all the options to OPEC.

15. If is possible (I am not sure of the facts) for surplus OPEC countries to secure some spread in the currency denomination of their assets by lending to the International Bank, the IMF, or other IFIs that issue SDR or foreign-currency debt. This need not depress the dollar if those Institutions hold their assets in dollars, and the subsidy on the exchange risk is not borne entirely by the United States.

cc: Messrs. Gemmill, Henry, Siegman, Shafer, Ms. Terrie

TREASURY DEPARTMENT

Oil Producer Demands for Indexation of Their Financial Assets

I. Introduction

Saudi Arabia and other OPEC participants in the Conference on International Economic Cooperation (CIEC) probably will pursue the indexation of financial assets formally in the dialogue. Thus, the Financial Affairs Commission (FAC) in CIEC will probably have to address the issue. At the Prepcon, the "Seven" proposed that the FAC discuss, inter alia, "the protection of the real value of financial assets." In the near term, they should be much more specific in defining the problem and in stating their request.

The investment being discussed in this paper is a liability, such as a bond -- whose interest and principal payments are linked to a general price index -- issued by industrialized country governments or a multinational financial institution to OPEC. The attractiveness of such an investment for an investor is the certain "real" rate of return and certainty that the "real value" of the principle will be maintained. The disadvantage of assets with more certainty is that they tend to be accompanied by lower returns.

The proposal for an inflation-proof investment is of concern because of the stated relationship between the path over time of the OPEC-set price of oil, which is necessarily related to OPEC oil production and the return from investing surplus oil revenues. For example, Saudi Oil Minister Yamani has stated that world inflation and fluctuations in exchange rates make it more profitable "to keep the oil in the ground than place its money equivalent in even the most lucrative investments." 1/

1/ Oil producers seem to be well positioned to hedge against exchange risks. In addition to spreading their investments more widely among currencies, some have denominated loans in SDRs. The basic point concerning exchange rate movements is that investment diversification among various currencies can provide a hedge against movements in exchange rates. This paper does not address further the exchange risk issue.

In view of the likelihood that the indexation of financial assets will surface in some form or another during the dialogue, the purpose of this paper is to: (1) review the analysis behind the basic position of industrialized countries that they will not issue indexed financial instruments to OPEC and (2) examine the analysis behind any possible relationship between oil prices and the return on OPEC investment. Such papers can help obtain a unified position among industrialized nations, which is crucial for a satisfactory settlement.

The issue of maintenance of value for certain OPEC investments is assumed in this paper to be separate from the broader question of whether indexation is a desirable feature of debt instruments provided by governments. This paper is not aimed at financial indexation generally, but only at whether there is a special case providing indexed financial instruments to a particular set of international investors. 2/

II. Industrialized Countries' Position and Policy Considerations

OECD discussions in the Temporary Working Party (TWP) of the Economic Policy Committee revealed strong and uniform opposition to the concept of providng indexed financial assets to oil producer investors. The TWP concluded:

"Indexation of the OPEC countries' financial assets would entail serious disadvantages for OECD countries. It would mean conceding to oil producers privileges denied to their own residents or to other non-residents in the field of asset indexation. The selective indexation of OPEC assets could distort yields between indexed financial assets, divert funds from non-indexed financial asset markets, and in the end, could lead to real resource allocation problems. It should therefore be strongly resisted."

2/ Most governmental efforts to issue indexed securities have been directed in large part at reducing the adverse distributional effects of inflation on small savers who have a limited ability to hedge against inflation. Such arguments have less validity for large governmental investors.

The evidence implies that the policy views (of industrialized nations) that we should resist the governmental granting of indexed financial instruments to OPEC is strong. Although several developed nations have unambiguously ruled out the issuance of special indexed asset for OPEC, it is nevertheless useful to review the reasons for this position.

<u>For Current Policy</u>

A. One argument is the lack of equity in extending to oil producers any advantage not granted all investors, particularly those in oil-consuming nations. Many other investors also have been hurt by the surges in inflation over the past several years. Special treatment of producers' investments would cause acute political difficulties for most host governments.

B. Offering an asset only to OPEC provides incentive to join OPEC and a disincentive for members to quit. Moreover, by providing a concession -- if the amount of real interest is high enough to be a concession -- we would essentially be ? more for oil from OPEC than from others. That is not equitable or justifiable.

C. Indexation of OPEC assets would partially isolate the producers from the negative consequences of their own actions on oil prices, and thereby reduce the incentive for them to keep price increases down. Cartel action on oil prices has significant effects on inflation, and the recent world inflation which concerns them has, to a significant extent, been the result of their own pricing action.

D. The relatively low rate of return on the financial assets of some oil producers is due in part to their high preference for liquidity. By investing heavily in these short term instruments -- on which interest is normally low -- they have driven these interest rates further down. Some OPEC members may provide the weak argument that a substantial portion of their foreign assets must be kept in liquid form because they are the foreign reserves of these countries. No nation is required to maintain huge reserves - particularly in an era of flexible exchange rates.

E. Apart from the liquidity preferences of certain OPEC nations, which has led to safe investments with limited returns, there is the quite unusual behavior of real interest rates themselves in recent years. In the 1973-74 boom, prices unexpectedly soared due to poor weather, the worldwide coincidence of rising demands and actions by OPEC nations. That unusual period of inflation led to a negative real rates of interest. In late 1974, as business conditions soured, monetary authorities allowed nominal interest rates to drop to encourage expansion. This also lead to low real rates of interest.

This period was unique. It is most probable that real rates of interest are returning to their long-term trend rate of 1% to 2%. Of course, this will reduce the frustrations of these particular OPEC nations with large investments in debt instruments, as well as many other creditors.

F. Because of their enormous wealth, OPEC investors are certainly well positioned to hedge against inflation over time by investing in a broad portfolio of real assets as well as debt instruments. In 1975, they have shifted both toward longer term debt instruments and real assets.

G. Indexation of financial assets by governments of industrialized nations is not necessary, since the private sector can accomodate these demands in a non-concessionary manner. One large U.S. bank, in response to a direct request from the Saudis, is in the process of developing a measure of "imported inflation" in Saudi Arabia to which some form of deposit instrument might be linked.

H. While creditor nations -- both in OPEC and in developed nations -- have lost over the last several years because of unanticipated inflation, the LDCs as debtors have gained. The large number of debtor nations in the LDC /OPEC block are unlikely to find the indexation of international borrowings a desirable issue.

Against Current Policy

A. If creditor nations are so fearful of inflation that they are willing to purchase large amounts of long term bonds with a very low real rate of return, perhaps it should be considered if two conditions are satisfied. First, that the issue can be made available for all investors -- an issue to be discussed in another paper. Secondly, that the overall administrative costs are justified.

B. If key OPEC nations perceive that the real rate of return of financial instruments through special issues is much higher than perceived before, there is a theoretical justification for them to cut prices immediately. Assuming they were optimizing profits in their pricing behavior previously, then a higher perceived return on financial assets would encourage them to sell more oil now (at lower prices) and buy more of these financial instruments. (After that one shot effect, however, the real oil price will tend to rise at the same rate as the newly perceived higher real interest rate.) In any event, the amount of this theoretical shift in prices is small the extremely small change in real interest rates that would likely be perceived by the major OPEC nations if a special issue were provided.

III. Oil in the Ground as an Alternative Form of Investment

It has been hypothesized that there is a strong relationship between oil price, oil production and the rate of return on which surplus oil revenues can be invested. Beginning in late 1973 -- coinciding with the period of the oil price increases and the financial flows associated with those increases -- nominal interest rates generally fell below rates of inflation in the industrialized countries (see Table). Some producers became concerned, therefore, with the prospect of exchanging an exhaustable resource, which they believe will appreciate in value in real terms for assets which they expect to paying in real value. The question is whether these producers are likely to gain by holding oil off the market.

Whether this is a sound strategy depends on several factors: the current and future prices of oil and the rate of return available to producers on invested revenues. Unless the price of oil is expected to rise at a rate greater than the return on these producers investments, it would not generally be in their interest to reduce production as part of an optimal investment strategy. In other words, in order to profitably store oil in the ground, the annual rate of increases of oil prices 3/ would have to be greater than the return on financial assets.

There are strong reasons to believe that oil prices are unlikely to rise in real terms. At present, there is enormous excess capacity. As many OPEC capital accounts decline, there will be instability within OPEC, as there will tend to be less willingness to share production shortfalls. At present prices, non-OPEC nations are beginning to produce more oil and oil substitures. Over the next five years, OPEC production rates are not likely to rise very much above the current rates, and a general condition of substantial excess capacity will continue.

Under our assumptions about demand and alternative supply, OPEC would lose proifts if they raised prices further now. Under their assumptions, they may think it would be profitable. Discussion in this arbitrary and argumentative area is not likely to be fruitful.

Some OPEC nations may feel that oil in the ground may offer greater political security than foreign investment. We can point to our record of encouraging the free flow of financial assets. Also, underground assets are not that safe from internal or external military forces, whereas external assets may be dispersed and concealed. Moreover, the LDCs dislike excessive underground holdings because it means higher oil prices. And LDCs are seeking more, not less, OPEC credit, and those credits will be less likely if oil is kept in the ground.

3/ Technically, the relevant variable is marginal revenue. But in a world in which OPEC and non-OPEC producers are co-existing as profit maximizers, the percentage increases in marginal revenues and oil prices are the same.

As evidenced by OPEC's policy splits concerning the pricing action in September 1975, OPEC is a tenuous organization whose political cohesion is limited by economic reality. Saudi Arabia and Kuwait, e.g., are flush with oil reserves and are unlikely to limit output and set prices so high now that the relative value of future recoveries is excessively lessened because of increased substitution by other energy sources.

IV. Conclusion

Investment problems faced by oil producers are probably not affecting their current production decisions. Foreign investment and domestic oil production decisions by OPEC are analytically quite separate. A small gain in the return for foreign financial assets that is likely to be perceived affects the theoretically optimum path of oil production to only a limited extent. Consumer countries should not be persuaded easily that producers require concessions in order to assure adequate oil liftings.

OPEC already may have set oil prices too high for maximum longterm profitability. But, if so, that is probably due to an error in its assumptions. It is doubtful that they would knowingly choose to be significantly less profitable by selecting excessively high prices.

OPEC nations for which financial indexation is an issue need the cooperation and military help of the U.S.

It may be that financial indexation is less a real issue for a small group in OPEC than a potential rationale for subsequent nominal rises in oil prices that will occur in any event.

TREASURY DEPARTMENT

Indexation of Financial Assets

Initial Strategy

In general, we should express our interest in hearing the case for financial indexation. A willingness to listen should be the key feature of our appraoch to the discussion of this issue. We should make OPEC substantiate its assertions about the effects of inflation on the purchasing power of their financial assets, just as we are doing on the terms-of-trade issue.

- We should get them to be specific in their proposals. By requiring OPEC to talk first, and at length, we should be able to determine their objectives on this issue and how seriously they intend to pursue them. It may be clear at the beginning that OPEC does not really expect a concession on this issue; they may be interested in making a case for financial indexation only in order to support their arguments or positions on other topics in the dialogue. Any LDC support OPEC may initially have on this issue is weak.

- A low key response may be all that is required from us.

Suggested Talking Points

1. We could ask what is the problem. We could seek an analysis of inflation and financial markets. We might ask OPEC to do a paper. We might usefully offer to do a paper ourselves on industrial country experience with financial indexation. (We could turn to the TWP, which could, in turn, ask the Committee on Financial Markets to pull together its extensive work in this area. The results of industrial country experiments with financial indexation are mixed, largely negative, and there are many technical difficulties.)

   - We could ask what is the specific real rate of return that individual investing nations have experienced. What is the specific breakdown of those investments? Perhaps the real return to their overall investments over the last few years have been satisfactory. Can it be shown that OPEC country official reserves have earned lower real rate than invested reserves of other countries? Not likely.

   - In free markets long term interest rates reflect the real rate plus the anticipated rate of inflation. Is there some evidence that financial markets are not working properly in adjusting to anticipated inflation? If indexation is worth the administrative expense for certain investors, is there some reason the private sector cannot accommodate demands for indexed assets?

-- Who should pay for the administrative expense of indexed financial instruments -- debtors or creditors?

-- The relatively low rate of return on some of the financial assets of some OPEC countries is caused in part by their high preference for liquidity. They are not required to keep such a large portion of their wealth in short-term instruments.

-- A wide range of assets (mainly equities and real assets) are available that offer protection against inflation. On the other hand, they have their own risks.

-- During recent years inflation has eroded the purchasing power of all financial assets ~~debt liabilities~~. Creditors and all holders of money have been hurt to some extent, not just OPEC.

not tactful

-- We can point out that the cartel's pricing policy has disrupted Western economies and financial markets. Their pricing policy has not been consistent with the price stability and the positive real interest rates that they desire.

We would have to index our [illegible] if [illegible] indexation to OPEC

-- While negative interest rates hurt creditors, they benefit debtors, such as the LDCs. We should point out that wide financial indexation would mean indexing assets other than just OPEC's, including the World Bank's loans to developing countries. Will OPEC also demand that LDC debt instruments be indexed before OPEC will buy them? (We should suggest the extent to which inflation over the past two years has lowered the real debt burden of the LDCs. Inflation over the past few years has significantly benefited debtors, countries as well as individuals).

-- Although real rates of return for certain short-term financial instruments have in recent years been quite low, this is little basis to believe that it will be true over the next several years. Is their analysis different? Do they want to be locked into instruments with low real rates of return?

Be careful - so we do not imply we are ready

2. We should encourage OPEC to spell out precisely what specific proposals they have in mind. What are the attributes of this asset they are seeking. Points to cover are:

-- Are they suggesting that redemption values or interest payments or both to be linked to the price elvel?

-- What do they consider to be the relevant prices: that of the issuing country, of the non-OPEC world, of export prices to OPEC, etc.? Is there an adequate price index for the prices in question?

-- Are they thinking of several countries issuing such a liability, individually or multilaterally? How would such a system work, i.e., several liabilities linked to differing national inflation rates?

-- Should such a special instrument have a long maturity? Is limited marketability acceptable?

-- How much of such assets would OPEC be willing to buy? Which specific nations would be willing to buy what specific amounts?

-- There is a trade-off for them (as lenders) and us (as borrowers) between a certain low real rate of return and a higher nominal but uncertain real rate of return. Do they actually expect us to offer them a high certain real return? What specific real rate of return do they require in order to invest?

3. For the developed countries there are enormous difficulties to financial indexation.

-- Offering these assets only to OPEC members is unacceptable to the industrial countries. Discrimination in favor of OPEC investors is not politically feasible, which should be fairly obvious to OPEC.

-- Providing such an asset to all investors would raise problems, too. Administrative costs would be quite burdensome.

-- Offering such assets to "small savers" would cause disintermediation. As a result, the housing market in many nations could be hurt.

4. An OPEC challenge that we offer them inflation-proof investments or face a sharp cut in OPEc production is unlikely. If they should pose this issue, however,

it probably cannot be countered conclusively on technical grounds. Their analysts will simply make different abritrary assumptions than ours. If OPEC expects the price of oil to rise at a rate greater than the return on their investments, they will believe it will benefit them to reduce production and store oil in the ground.

-- OPEC may attribute a high degree of safety, which it values highly, to oil in the ground. Most investors consider a broad portfolio of assets to be superior.

Energy Commission is [illegible] place

-- A discussion of this subject would be a subjective exercise. It would be political. And it is too argumentative. Thus, it should be avoided.

-- The line to take on this issue is to emphasize our common interest in promoting harmonious economic and financial relationships among all nations, that the oil price increases were large enough to offset any attrition through inflation for years to come, and that the difficulties of the oil consuming countries in adjusting to their cartel pricing have negative consequences for them as well as us.

Clearances: Treasury: Mr. Witherell (3/9/76)

APPENDIX 4.—MATERIAL ON U.S. GOVERNMENT PREFERENTIAL TAX TREATMENT FOR OPEC GOVERNMENTS INVESTING IN U.S. REAL ESTATE AND BUSINESSES (DIRECT INVESTMENTS)

A. CHAIRMAN'S 8/13/81 LETTER TO TREASURY DISCUSSING AND SEEKING INFORMATION ON FOREIGN GOVERNMENT INFLUENCE OVER U.S. TAX POLICY AND PROMULGATION OF IRS REG. 1.892–1; RELATED MATERIAL; AND CONGRESSIONAL RESEARCH SERVICE MEMO OF 8/29/80

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NINETY-SEVENTH CONGRESS

Congress of the United States

House of Representatives

COMMERCE, CONSUMER, AND MONETARY AFFAIRS
SUBCOMMITTEE
OF THE
COMMITTEE ON GOVERNMENT OPERATIONS
RAYBURN HOUSE OFFICE BUILDING, ROOM B-377
WASHINGTON, D.C. 20515

August 13, 1981

Hon. John Chapoton
Assistant Secretary for Tax Policy
U.S. Department of the Treasury
Washington, D.C. 20220

Dear Assistant Secretary Chapoton:

The Subcommittee on Commerce, Consumer, and Monetary Affairs of the Committee on Government Operations is continuing its examination of the adequacy of Federal efforts to monitor and oversee foreign investment in the U.S. -- both direct and portfolio investment. One aspect of our inquiry concerns U.S. tax policy relating to OPEC investments in the U.S.

The subcommittee has reviewed numerous documents -- both State Department and Treasury -- relating to the promulgation of IRS regulation 1.892-1, finally issued in July 1980, to tax certain income earned by foreign governments. These documents -- which reflect secret, ex-parte communications between foreign governments and U.S. officials and substantial changes in the regulation subsequent to these communications -- raise important issues concerning the nature and extent of foreign influence over U.S. tax policy and the administration of our tax laws.

In order to better understand the influence over tax policy by foreign governments and Federal entities not normally involved in the tax policy process, I am writing to request that knowledgeable persons within the Treasury Department, involved with the promulgation of the regulation, brief the subcommittee staff at the earliest opportunity. We would like to schedule this briefing for September 2, 1981, in Room 2203 Rayburn House Office Building at 9:30 a.m. In preparation for the briefing, we request that Treasury conduct a further search for any relevant documents and make inquiry of former Treasury officers for any information to which only they were privy.

BACKGROUND

Section 892 of the IRS Code never specifically addresses the question of taxing income earned by foreign governments on extensive commercial and business activities in the U.S., including ownership of real estate. Prior to the early

1970s and the large inflows of OPEC country government surplus funds into the U.S., there was apparently very little foreign government investment in U.S. business and U.S. real estate. When Section 892 was enacted in 1918, Congress did not foresee much commercial investment, because most foreign government investment involved relatively liquid assets for normal foreign exchange and reserve requirements. This accounted for Section 892's ambiguity and uncertainty.

As OPEC government investments increased, in 1975 and 1976 the IRS issued an increasing number of revenue rulings on 892, narrowing the breadth of this exemption in the face of the ambiguity, to tax income from commercial and real estate investments. Underlying these rulings was a recognition that OPEC governments possessed an unfair advantage relative to the U.S. taxpayer undertaking similar activities. Because this piecemeal approach was inadequate, in 1976 the Treasury decided to promulgate a regulation to narrow the breadth of the exemption, heretofore allowed foreign governments.

The Section 892 regulation, as initially proposed in August 1978, would have taxed income earned by foreign governments from the active conduct of a trade or business. Under the proposal, income earned from real estate activities, including net leases or income from the sale of unproductive land, would have been subject to taxation; the regulations would have been retroactive in part (see Treasury Document C6); and dividends and interest from the ownership of stocks and bonds would have been exempt from taxation, but only to the extent not "effectively connected" with a trade or business.

Shortly after the regulation was proposed, several Middle East OPEC governments expressed their strong opposition. As noted in Treasury Document C6,

> Certain foreign sovereigns, including Kuwait, have objected to the proposed regulations. These sovereigns have acquired real estate in the U.S. such as shopping centers and commercial office buildings which are leased on a conventional and net lease basis.

Pressure was applied to the U.S. by one or more Middle East OPEC governments in opposition to the proposal. A summary of an Executive Agency's (not Treasury's) internal memo of a late 1978 meeting abroad between a senior Middle East government official and a U.S. official (Agency Doc. 22) is indicative of the type of action threatened if the regulations were implemented and that nation's real estate investments taxed:

> They /the M.E. OPEC government/ consider the matter "highly sensitive" given the relationship between their government's oil production and investment possibilities....
>
> ...the foreign government official replied, "I am not looking at the matter from the financial side, but from the oil side. The only incentive we have to produce is that we can use the proceeds to invest--to exchange one asset for another." The oil ministers of the OPEC surplus countries, he said, would come under increasing pressure if they assumed their investments were under pressure. Finance ministers in surplus countries do not necessarily wish to accommodate oil customers if there is no place to invest added income. His country has very good longstanding rela-

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> tionships with U.S. financial institutions /several of whom are involved with real estate investments/. It does not wish to change because of Section 892 complications.

A September 1978 memo (Treasury Doc. 65) from one senior Treasury official (Office of Assistant Secretary for International Affairs -- hereafter "OASIA") to another senior official reports that [Deleted at Treasury's Request] The State Department was advised by a Mideast government in June 1979, (unnumbered summary of State Department cable), that that government had placed a freeze on certain investments "because of uncertainty as to the application of new IRS regulation." As noted in the cable, because of Section 892 uncertainty, that government indicated:

> ...with respect to other investment, his government, in view of Section 892 uncertainty, will probably establish offshore companies in the Bahamas, etc., similar to those set up by another Mideast government, through which it would conduct real estate investments....
>
> Naturally, if the IRS gives a more favorable interpretation to its revised regulations, the government of this country is likely to invest more in U.S. real estate because of the greater return it would receive.

The Middle East OPEC pressure was relayed by the State Department in numerous cables and by senior OASIA officials, which basically endorsed the positions taken by OPEC governments.

Intervention by OASIA within Treasury may have been the principal cause of major changes in the final regulation. That final regulation exempted from taxation (1) net lease income, (2) income earned from the sale of non-productive property, and (3) dividends and interest from an active trade or business 100 percent owned by the foreign government. Further, the regulation was made prospective only, but could be applied retroactively at the discretion of the foreign government if it benefited the government.

I

We have questions about these changes in the regulation and the events which brought them about. The briefing should respond to the questions and requests for further information, as set forth below:

<u>Retroactivity and Prospectivity -- The effective date of the regulation.</u>

State Department summaries of cables (numbered 1, 2, & 8) indicate that the head of a Middle East OPEC government was extremely concerned that the regulations would be made retroactive and involve extensive tax liability. In October 1978, legal counsel for a major U.S. bank advised the State Department of the substance of a conversation with an OPEC government official:

> ...foreign government officials...regarded this issue "as a most delicate political matter." He added that senior U.S. Official's forthcoming meeting could be extremely unpleasant if IRS proposal was implemented. He further indicated that those officials thought IRS was politically motivated in

regard to this proposed regulation. (From State Dept. summary of cable, no. 8.)

Around the same time, in another meeting between a U.S. Official and senior officials of a Middle East Government, (summarized in [Deleted]* Doc. No. 22), the same subject was discussed. The cable states:

> Another senior U.S. Official was very much aware of the problem and would bring with him a tax specialist to discuss the matter with them. Senior U.S. Official stated his view that retroactivity would be extremely undesirable. He was sure that the USG would try to resolve the matter in a way which would cause minimal disruption. U.S. policy is to be as hospitable as possible to foreign investment.

We require responses to the following:

1. Treasury Document 56 (2 buck-slips) indicates that on October 20, 1978, Deputy Secretary Robert Carswell told Assistant Secretary for Tax Policy Lubick that he wanted to "discuss the retroactivity point further before /the regulations/ are made public." On October 23, 1978, Emil Sunley sent a short memo to David Rosenbloom (both within Tax Policy) indicating that they would have to "have a conference with Mr. Carswell on the retroactivity point."

    a. Who attended this conference and when was it held?

    b. What points did Mr. Carswell want discussed and what were his concerns? What points were expressed by others at the conference?

    c. What decisions were made at this meeting on the retroactivity issue or on any other aspects of the regulation and who made them?

2. "Talking Points: Status of foreign government real estate investment", Treasury Document 51, states:

    > The argument for prospective-only application is supported to some extent by published (but obsolete) IRS rulings. We believe that relief may be available but there are certain problems and we will have to discuss the issue with IRS."

    (See also Document C5.)

    a. Identify and discuss the obsolete published IRS rulings referred to? (Please have them brought to the briefing.)

    b. Explain in detail the "certain problems" alluded to. How were these problems resolved?

3. The American Law Division of the Congressional Research Service researched for us the issue of effective regulations dates. They advised the subcommittee that regulations with elective effective dates, that can be applied retroactively by the taxpayer if beneficial but which are otherwise prospective, are "relatively unusual." He was unable to find any prior regulation with this feature.

*NAME OF U.S. EXECUTIVE BRANCH AGENCY DELETED AT AGENCY'S REQUEST.

a. Cite past regulations utilizing the particular type of elective option used in 1.892-1; indicate the subject of those regulations and the rationale for such a procedure.

b. Who first suggested such an option with respect to the present regulation? Was it the IRS, an OPEC Government representative or someone else? Was there any opposition within Treasury or IRS to it?

c. Describe the circumstances surrounding the adoption of the elective effective dates.

4. Rather than make the regulations completely retroactive or prospectively only, there were other alternatives, including making them retroactive to the date of the proposed regulation (August 1978). A summary of cable 2, a September 1978 State Department cable, suggested that the U.S. Embassy advise a concerned Middle East OPEC government that:

> ...the regulation would generally only be retroactive to a three-year limit, as the IRS has a statute of limitation.

Treasury was aware that it had other options. And, in fact, an October 19, 1978, memo to Deputy Secretary Carswell from Mr. Lubick, (Treasury Doc. C3), states:

> A contrary consideration /to making the regulation retroactive indefinitely/ is that in 1976, withholding agents of /name of country/ were specifically advised that the IRS and Treasury take the view that real estate and other commercial activities are taxable and are not exempt under section 892. Thus, we must consider the question of prospective relief (at least prior to 1976) very carefully for taxpayers or withholding agents that had received notice that the exemption of section 892 is restricted to government activities and income.

(See also Treasury Document 17.)

a. Why didn't Treasury make the regulation retroactive to the 1976 date when withholding agents were advised that "real estate and other commercial activities are taxable and are not exempt under Section 892", as suggested in this October 1978 memo?

b. Why didn't Treasury consider other options, such as one of the most commonly used effective dates: retroactivity to the date of issuance of the proposed regulations?

c. How much tax revenue do you estimate the U.S. Treasury has lost (1) because the regulations were made prospective only and not retroactive to (a) 1976 or (b) August 1978 and (2) because of the elective procedure allowing foreign governments to utilize the regulation to benefit them?

<u>Controlling Interest Stock Investment</u>

Dividends "effectively connected" with the conduct of a trade or business within the U.S. would have been taxed under the August 1978 regulation, as proposed. Specifically, ownership of stock would have been considered a commercial activity, the income from which would be taxed, if that ownership conferred sufficient control over the conduct of a trade or business. The final regulation took the opposite position. Listed as an "investment activity", (the income from which would be tax exempt) are:

> Investments in the U.S. in stocks (whether or not a controlling interest investment),....(Subsection (c)(2)(i), final regulation.)

Thus, if a foreign government structures its investments as stock ownership, it will effectively shelter all income, even if it is involved in the conduct of a trade or business. Two staff members in Treasury's Office of Tax Policy recognized this. A February 11, 1980, memo from Mr. Halperin to Mr. Krupsky, within the Office of Tax Policy (OTP) (Treasury Doc. 9) comments on this change and states:

> The parenthetical /about "controlling interest"/ adopts the position...that ownership of stock *per se* is always a capital investment rather than a part of an active business. Here, that position permits a foreign government to own and manage a shopping center through a controlled subsidiary, pay no tax at the corporate level because of deductions and take out the cash flow as dividends without tax. Since any foreigner can do that now through the Antilles, I suppose one can't object to a government doing it. However, if our real estate proposal (The Wallop bill) is adopted, there might be more pressure on the position taken in the parenthetical.

The briefing should respond to the following questions:

1. When was this exemption (on income earned from a controlling interest of stock in trade or business) actually considered within the IRS and Treasury? When was a final decision made? Describe the circumstances surrounding this change.

2. Who first proposed the broadening of this exemption? Who gave the final approval on this particular issue before final approval was given on the entire regulation?

3. Doesn't this exemption provide a relatively easy means to circumvent the goal of the regulation, *i.e.* to tax income earned through non-governmental commercial activities, by allowing a foreign government to structure a trade or business through stock ownership? If not, give examples of investments which could not be structured in a stock ownership arrangement.

Net leases and other exemptions

Under the regulation as proposed, income from net leases and the sale of unproductive land would have been taxed. However, intervention by high Treasury officials from the Office of the Assistant Secretary for International Affairs (OASIA) and concern by the Secretary about discouraging OPEC real estate investments apparently resulted in exemptions for net lease income and for income earned from the sale of non-productive land. Also, those exemptions were made complete by a provision that an investment activity will not cease to be one "solely because of the volume of transactions of that activity...". The above is based on the following analysis:

A November 16, 1979, Treasury Office of Tax Policy memo, (Treasury Doc. 17), advises Secretary Miller that one Middle East OPEC country asked that all government income, particularly real estate and net lease income, be exempt. (The government had repeatedly made these requests.) The Office of Tax Policy indicated that these requests had not been granted.

However, on December 21, 1979, Mr. Lubick sent a lengthy memo to the Secretary (Treasury Doc. 13), in response to the Secretary's inquiry on whether the Middle East government should be taxed on its real estate investments. In that memo, Mr. Lubick recommended a reversal of Treasury's long-standing position to tax net leases. He specifically recommended exempting net lease income from taxation and income earned from the sale of unproductive land. Notwithstanding his recommendation, Mr. Lubick did state some strong reasons for not allowing such an exemption:

> The draft regulations would tax rental income in all cases. It is argued that exempting net lease income would be unfair to U.S. persons engaged in similar transactions. It may be noted, however, that because of depreciation deductions, such income is generally subject to little tax in any event, except perhaps in cases of holdings limited to land and not the improvements thereon.
>
> It may, in these circumstances, be unwise to risk the potential administrative problem which could arise from an effort to distinguish among various forms of fee ownership. Furthermore, /country deleted/ has been unwilling to furnish us with details as to their recent investment activities. Attempting to draw a line without this information may well be unproductive. If /country deleted/ views the regulation merely as a symbol of our attitude toward their investment in the U.S., enlarging the category of tax-free investments may not gain as much if we fail to include the bulk of /country deleted/'s investment in the tax-free category. /Emphasis added./

Additional reasons for not exempting net lease income were stated in a proposed transmittal memo from IRS Commissioner Kurtz to Mr. Lubick, buck slip dated October 30, 1979, (Treasury Doc. 18). It states on page 4:

> The net lease issue illustrates how the more limited "engaged-in-a-trade-or-business" rule could conflict with the policy approach taken in these regulations. While it is possible that holding one net lease would not constitute a trade or business, holding several might, and it would be difficult to determine the point at which the "trade or business" line is crossed and to justify a distinction based upon the status of the leasing activity. In any case, regardless of the extent of the leasing activity, granting tax exempt status to the activity would permit the foreign government a competitive advantage over U.S. taxpayers engaged to the same degree in net leasing activities. (Emphasis added.)

(See also Treasury Document 21.)

Shortly after Mr. Lubick's December 21st memo, Mr. Hufbauer (OASIA) sent a January 7, 1980, memo to Assistant Secretary (OASIA) Bergsten and Under Secretary Solomon (Treasury Doc. 12), urging a more restrictive reading of Section 892, IRS Code, arguing against any taxation of a foreign government's income. The memo states that the proposed regulation:

> will significantly reduce the range of U.S. inflation-proof assets...attractive investment vehicles to...oil producing nations. This point is significant if the elasticity of oil supply is at all connected to the opportunity to invest in secure assets, other than gold, which yield a positive rate of return.

The memo recommends that the Secretary be asked whether the regulation "is inconsistent with broad policy goals." On January 9, 1980, a senior Treasury official within OASIA, wrote a memo to Secretary Miller, (Treasury Doc. 13), in which he argued against the regulation on both legal and policy grounds. The memo states:

> On the other hand, it is anomalous for a foreign government to engage in "commercial activity" in the U.S. and not pay U.S. withholding taxes on the income.
>
> As a practical accommodation, therefore, I recommend that the regulation spell out a safe-haven list of types of "non-commercial" income that will fall within the protection of Section 892 when received by a foreign government. /Handwritten below and inserted at this point in the memo is the following:/ For example: (1) ownership of office buildings or warehouses which are net leased, (2) idle land (including timber land), (3) mortgage trust deeds. /The memo continues:/ These sale-haven types of income would be protected whether or not they are "effectively connected" with a U.S. trade or business. Under this approach, types of income not on the safe haven list would be subject to close scrutiny on a case by case basis.

On January 16, 1980, the Secretary expressed concern about the "narrowness of exemption provided foreign governments". (From February 8, 1980, memo to Rosenbloom from Hannes, OTP, Treasury Doc. 10.) Apparently there was concern about discouraging OPEC government real estate investments in the U.S. The memo states:

> The Secretary appears to be concerned primarily about real estate. OASIA and OTA economists believe that at least certain foreign generated investments, in particular real estate investments, are made here largely independent of U.S. tax consideration. Broad economic and political concerns are the principal motivations for such investments. The views of the economists on real estate suggest that the Secretary need not be too concerned about barriers on real estate investment. (Emphasis added.)

Notwithstanding this view, on March 4, 1980, Mr. Lubick wrote a memo to Secretary Miller, (Treasury Doc. 7), in which he set forth the final decisions (1) to exempt net lease income, (2) to disregard the volume of transactions of an activity in determining whether income is commercial (taxable) or investment (non-taxable), (3) to exempt income earned from private placements of debt, (i.e. loans) by foreign government with U.S. businesses, and (4) to exempt dealer-earned income in connection with investment activities.

Attached to that memo is a buck-slip memo to Mr. Bergsten from his deputy Gary Hufbauer, (attached to Document No. 7), which states:

> /The regulation/ meets our earlier objections in a satisfactory manner and we recommend that you approve it.

1. The November 16, 1977, memo from Treasury's Office of Tax Policy (Treasury Doc. 17), stated that Tax Policy had denied foreign government requests that all their U.S. income, particularly real estate net lease income, be net exempt. Why, one month later, did the Office of Tax Policy reverse its position on the net lease issue? (Describe meetings, conversations, or other discussions on this issue taking place during this period.)

2. We have several questions about the involvement of the Treasury officials within OASIA:

   a. The three safe-haven types of income, suggested by a senior Treasury official within OASIA (January 9, 1980 memo), were effectively incorporated in the final regulation. At any time did any officials of a Middle East OPEC government suggest to OASIA staff or officials an exemption for (1) commercial buildings which are net leased, (2) the sale of idle land, including timber land, and (3) mortgage trust deeds? If not, how did each of these proposals develop and who was involved?

   b. As noted in the buck slip (part of Document 7), OASIA staff recommended that Assistant Secretary Bergsten approve the final regulations, because their objections had been resolved. (1) Please cite the regulations, internal policy directives, or other procedures conferring on the Assistant Secretary for International Affairs approval authority over IRS/Treasury regulations or rulings. (2) If none exists, why was OASIA allowed to approve or at least to significantly influence the decisions taken on this regulation? (3) If OASIA has attempted to influence the outcome of other IRS regulations, decribe the regulations involved, the positions taken by OASIA, and the eventual outcome.

3. Treasury Document 13, cited above, and several other memos, such as Treasury Document 308, make clear that Treasury wanted to know how a Middle East Government was structuring its real estate investments in the U.S. to determine whether income from their investments would be taxed. As noted by Assistant Secretary Lubick, (Doc. 13), the country involved had been unwilling to furnish the U.S. with details of its recent investment activities. Since this OPEC country is the primary real estate investor among OPEC governments, why were exemptions for certain of its real estate income allowed, without knowing the true extent of its investments?

4. The net lease portion of the regulation has not been finalized. What aspects of the regulation are being questioned or opposed by OPEC governments or their representatives? What other problems have surfaced?

II

General Concerns

The briefing should respond to the concern that U.S. tax policy, embodied in this regulation, appears to have been effectively influenced by secret, ex-parte communications between a Middle East OPEC government and U.S. Officials and through threats, by that foreign government, to reduce oil production and to decrease their investment, if favorable or preferential tax treatment was not received. Apparently, this pressure outweighed (1) the view within OTP that these investments would be made in the U.S. because of numerous beneficial investment opportunities, irrespective of tax considerations, and (2) the resulting unfair competitive advantage which OPEC governments possess over U.S. taxpayers holding similar investments, (such as the ability to charge lower rents or sell land at lower prices). We are particularly troubled by the degree to which the Treasury Department allowed such pressure to be applied by OASIA -- a part of Treasury in no way responsible for the administration of the tax laws -- and the extent to which it affected former Secretary Miller's decisions, overruling equity and other countervailing considerations. (See 24th Report of the Committee on Government Operations, 95th Congress, "Foreign Tax Credits Claimed by U.S. Petroleum Companies", which recommended that Government agencies, including divisions within Treasury, not responsible for the administration of the tax law be prohibited from influencing IRS rulings and other IRS actions.) We would like each of these concerns discussed.

Also, indicate any actions Treasury is now prepared to take to prevent any future recurrences of this type and to narrow or reconsider the breadth of the exemptions in the regulation at issue.

Finally, we would like to know how much money is lost to the Treasury because of the exemption contained in 892? (If no precise figure exists, please estimate and give the basis for such.)

If you or your staff have any questions about this inquiry or the briefing, please contact Subcommittee Counsel Stephen R. McSpadden. As we understand, Russell Munk in Treasury's General Counsel's office has copies of all Treasury and State Department documents cited. Thank you for your anticipated cooperation.

Sincerely,

Benjamin S. Rosenthal
Chairman

BSR:mv

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NINETY-SEVENTH CONGRESS

Congress of the United States

House of Representatives

COMMERCE, CONSUMER, AND MONETARY AFFAIRS SUBCOMMITTEE
OF THE
COMMITTEE ON GOVERNMENT OPERATIONS

RAYBURN HOUSE OFFICE BUILDING, ROOM B-377
WASHINGTON, D.C. 20515

September 30, 1981

Hon. John Chapoton
Assistant Secretary for Tax Policy
U.S. Department of the Treasury
Washington, D.C. 20220

Dear Assistant Secretary Chapoton:

On August 13, 1981, I wrote to you requesting a briefing of subcommittee staff on important issues surrounding the promulgation of IRS regulation 1.892-1, taxing certain income earned by foreign governments. Since then, based on a telephone conversation of September 21, 1981, between you and subcommittee counsel Stephen R. McSpadden, you and your staff have requested that the briefing and document production be postponed to Friday, October 23, 1981, because of scheduling conflicts and Treasury testimony on foreign tax treaties.

We are agreeable to such a postponement. Accordingly, the briefing will be held on October 23, 1981, in the subcommittee offices, beginning at 9:30 a.m. At that time, please bring with you any Treasury documents, relevant to our inquiry, not heretofore furnished to the subcommittee.

Please contact Stephen R. McSpadden if there are any questions.

Sincerely,

Benjamin S. Rosenthal
Chairman

BSR:mv

[SUBCOMMITTEE NOTE: Briefing was held on the date and time noted in the following letter.]

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

October 9, 1981

Mr. Stephen R. McSpadden
Counsel
Subcommittee on Commerce, Consumer
and Monetary Affairs
Committee on Government Operations
B-377 Rayburn House Office Building
Washington, D. C. 20515

Dear Mr. McSpadden:

This will confirm our recent conversation concerning the change in timing from 9:30 AM to 2:00 PM on Friday, October 23, for Mr. Chapoton to brief the Subcommittee staff on the taxation of certain income earned by foreign governments.

As we discussed, Mr. Chapoton has been requested to testify on the morning of October 23 which precipitated the change in the briefing time.

Your cooperation in this matter is appreciated.

Sincerely yours,

Marie A. Crane

Marie A. Crane
Confidential Secretary

[SUBCOMMITTEE NOTE: The two revenue rulings, referred to on p. 13 of the Chairman's 11/13/81 letter to Assistant Secretary Chapoton, follow:]

mined should be (*a*) increased or decreased, as the case may be, by the amount of any section 452 adjustment attributable to each company, and (*b*) decreased by the amount of the consolidated credit for foreign taxes attributable to each company. In the event that the income taxes paid to a foreign country or United States possession are in excess of the amounts allowed as credits, the excess should be taken into consideration in arriving at the earnings and profits. (For similar method under prior law, see I. T. 3637, C. B. 1944, 258, and I. T. 3692, C. B. 1944, 261.)

SECTION 29.115-4: Distributions other than a dividend.

INTERNAL REVENUE CODE

Regulations 111 amended. (See T. D. 5899, page 63.)

SECTION 29.115-6: Distributions from depletion or depreciation reserves.

INTERNAL REVENUE CODE

Regulations 111 amended. (See T. D. 5899, page 63.)

SECTION 116.—EXCLUSIONS FROM GROSS INCOME

SECTION 29.116-2: Income of foreign governments, international organizations, and their employees. 1952-11-13828 I. T. 4082

INTERNAL REVENUE CODE

A railway system which is owned and operated by a foreign government, and is so closely integrated with the executive arm of such government as to be a part thereof, is exempt, under section 116(c) of the Internal Revenue Code, from United States income tax on income from sources within the United States. Compensation received by the railway system's employees who are not citizens of the United States is exempt from United States income tax under section 116(h) of the Code, provided proper certification is made as required by section 116(h)(2) of the Code.

Advice is requested whether the income, from sources within the United States, of a railway system which is owned and operated by a foreign government is exempt from tax as income of the foreign government within the meaning of section 116(c) of the Internal Revenue Code, and whether compensation received by its employees is exempt from United States income tax under section 116(h) of the Code.

The railway system (sometimes hereinafter referred to as Railways) is not a corporation, it has no shares or shareholders, and no private interests are involved. Railways is under the supervision of a director general who is appointed by the president of the foreign government which owns it. The director general must submit an annual budget for Railways to the president for approval. Settlement of all but minor claims against it, increases in fares, and the abolition of railway stations are all subject to presidential approval.

The revenue of Railways is derived primarily from passenger and freight traffic and is used for its own expenses. Railways is not subject to taxes, national or local. Amounts derived from sales taxes collected by it on fares, freight, and services rendered are added to the service rates collected by it and are retained for its benefit. If Railways should require financial assistance from the government for its operations for any year, the director general so indicates before July 1 of the preceding year so that the president may fix the amount to be allocated for such purpose in the proposed national budget. In several instances, the government has enacted special legislation appropriating additional funds for the use of Railways.

Railways is authorized to issue bonds in limited amounts, secured by its own resources, subject to the approval of the president. The major borrowing, however, is accomplished by loans guaranteed by the government. The salaries of the director general and of virtually all of the employees of Railways are fixed by law. Details of employment, such as periodic salary increases and employment of persons related by blood or marriage, are regulated by law. Employees of Railways who work in the United States are given official government passports of the type issued only to individuals regarded as government employees or officials. The visas which the United States Government grants to such employees classify them as government officials.

Section 116 of the Internal Revenue Code provides that specified items, including the following, shall not be included in gross income and shall be exempt from tax:

(c) Income of Foreign Governments and of International Organizations.—The income of foreign governments * * * received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments * * * or from interest on deposits in banks in the United States of moneys belonging to such foreign governments * * * or from any other source within the United States.

* * * * * * *

(h) Compensation of Employees of Foreign Governments or of the Commonwealth of the Philippines.—

(1) Rule for exclusion.—Wages, fees, or salary of any employee of a foreign government * * * (including a consular or other officer, or a nondiplomatic representative), received as compensation for official services to such government * * *

(A) If such employee is not a citizen of the United States * * * and

(B) If, in the case of an employee of a foreign government * * * the services are of a character similar to those performed by employees of the Government of the United States in foreign countries * * * and

(C) If, in the case of an employee of a foreign government * * * the foreign government * * * grants an equivalent exemption to employees of the Government of the United States performing similar services in such foreign country * * *

(2) Certificate by Secretary of State.—The Secretary of State shall certify to the Secretary of the Treasury the names of the foreign countries which grant an equivalent exemption to the employees of the Government of the United States, performing services in such foreign countries, and the character of the services performed by employees of the Government of the United States in foreign countries. * * *

The railway system in the instant case is so closely integrated with the executive arm of the foreign government as to be a part thereof. (See *Louis Vial* v. *Commissioner*, 15 T. C. 403, acquiescence, page 4), this Bulletin. But *cf.* I. T. 3789, C. B. 1946-1, 100, in which it is held that a *corporation* wholly owned by a foreign government is an entity separate and distinct from such government.)

Accordingly, it is held that income received by the railway system from sources within the United States is exempt from United States income tax under section 116(c) of the Internal Revenue Code. It is also held that compensation received by the railway system's employees who are not citizens of the United States is exempt from United States income tax under section 116(h) of the Code, provided proper certification is made as required by section 116(h)(2) of the Code.

SECTION 117.—CAPITAL GAINS AND LOSSES

SECTION 29.117-1: Meaning of terms.

INTERNAL REVENUE CODE

Gain from sale of securities by an officer or director of a corporation where an amount is paid to the corporation under section 16(b) of the Securities Exchange Act of 1934. (See I. T. 4069, page 28.)

SECTION 29.117-1: Meaning of terms.

INTERNAL REVENUE CODE

Regulations 111 amended. (See T. D. 5881, page 56.)

SECTION 29.117-1: Meaning of terms.

INTERNAL REVENUE CODE

Modification of Mimeograph 6243 (C. B. 1948-1, 44) relating to futures trading. (See Mim. 6789, page 38.)

SECTION 29.117-6: Gains and losses from short sales; in general.

INTERNAL REVENUE CODE

Regulations 111 amended. (See T. D. 5881, page 56.)

SECTION 29.117-7: Gains and losses from involuntary conversions and from the sale or exchange of certain property used in the trade or business. 1952-7-13791 Mim. 6776

Treatment under section 117(j) of the Internal Revenue Code of gains realized upon the sale of livestock held for draft, breeding, or dairy purposes.

Mimeograph 6660 (C. B. 1951-2, 60) revoked.

SECTION 213(b), ARTICLE 83: Income of foreign Governments. 15-20-844 O. D. 448

Interest credited by a domestic bank to the account of a foreign bank, part of whose stock is owned by a foreign Government, is not exempt from income tax under section 213(b) 5 of the Revenue Act of 1918.

SECTION 213(b), ARTICLE 83: Income of foreign Governments. 18-20-895 O. D. 483

Income from sources within the United States received by a foreign ruler in his individual capacity is subject to income tax. Income received by him from property belonging to the Crown is not.

SECTION 213(b), ARTICLE 83: Income of foreign Governments. 21-20-951 O. D. 515

Inasmuch as section 213(b) of the Revenue Act of 1918 expressly provides that the income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to such governments, or from any other source within the United States is exempt from taxation, it is held that a foreign government is not subject to tax on income derived from the operation of vessels owned by such government through its agents in the United States. Neither is the foreign government liable to tax upon the income arising from the operation for its benefit of vessels chartered by it.

SECTION 213(b) ARTICLE 84: Income of States. 18-20-896
(Also Section 219, Article 341.) S. 1374

INCOME TAX—REVENUE ACT OF 1916, AS AMENDED BY THE REVENUE ACT OF 1917.

> Where executors under a will hold property specifically bequeathed to a governmental agency of a State, and other assets of the decedent's estate are sufficient to pay all debts, income received by the executors during the period of administration from such property is not taxable in the hands of the executors under section 2(b) of the Revenue Act of 1916.

Opinion is requested as to whether income from property specifically bequeathed to a State university constitutes taxable income in the hands of the executors under the decedent's will, when other assets of the estate are sufficient to pay all debts.

Section 2(b) of the Revenue Act of 1916, provides in part, as follows:

> Income received by estates of deceased persons during the period of administration or settlement of the estate, shall be subject to the normal and additional tax and taxed to their estates, and also such income of estates or any kind of property held in trust, including such income accumulated in trust for the benefit of unborn or unascertained persons, or persons with contingent interests, and income held for future distribution under the terms of the will or trust

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August 29, 1980

To : House Government Operations Committee
Subcommittee on Commerce, Consumer, and Monetary Affairs
Attention: Steve McSpadden, Counsel

From : American Law Division

Subject : Effective Date of the Regulations on Internal Revenue Code Section 894 -- Taxation of Foreign Government Income

This memorandum has been prepared pursuant to your inquiry of August 28, 1980, as discussed in our telephone conversation of that date, in which you requested an explanation of the effective date of Treasury Regulations sections 1.892-1, on taxation of income of foreign governments. 45 Federal Register 48882-85 (July 22, 1980).

Section 7805(b) of the Internal Revenue Code of 1954 (Code), states that the Secretary of the Treasury may prescribe the extent, if any, to which regulations will be applied without retroactive effect. The obvious import of the language chosen for section 7805(b) is that, absent express language, all regulations are to be applied retroactively. See also Dixon v. United States, 381 U.S. 68 (1965) (retroactive application of Treasury regulation permitted).

The general policy of the Treasury appears to be that regulations changes which would be detrimental to the taxpayer are made prospectively, and changes which are beneficial to the taxpayer are made retroactively, to all open years. Amendments to regulations which merely clarify present ambiguities are applied retroactively. See discussion in Rogovin, "The Four R's: Regulations, Rulings, Reliance, and Retroactivity--A View from Within," 18 University of Chicago Tax Conference (1965).

The final regulations issued under Code section 892, on taxation of income of foreign governments and their instrumentalities and related entities, are made effective: "to income derived by a foreign sovereign after July 22, 1980, unless the sovereign elects to have it apply to income derived before that date." 45 Federal Register at 48885. The impact of this effective date would appear to be to make the regulations prospective, except to the extent they benefit a foreign government or related party, which can elect to apply them retroactively.

Such an elective effective date appears to be relatively unusual for tax regulations. The following is a summary of the 20 most recent final regulations (issued as Treasury Decisions [T.D.]), and their effective dates. When it is apparent why a particular effective date was selected, it is noted. It may be observed that the effective dates of regulations vary significantly. Some of the regulations have been retroactive to the date of issuance of the proposed regulations, or to the effective date of the interpreted statute. Other regulations have been merely prospective in application. However, in no instance other than the regulations under section 892, were taxpayers given an option with respect to the effective date of the regulations.

1. T.D. 7714 (Final regulations under Code §§ 219, 408, on individual retirement arrangements). Various provisions were effective generally for taxable years beginning after 1978, though some were effective for taxable

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years beginning after 1977, and certain transactions on or before April 15, 1976 are not taken into account for one provision. 45 Federal Register 52782-52800.

2. T.D. 7712 (Final regulations under Code § 956(b), on investments in U.S. properties by controlled foreign corporations). Effective for all taxable years beginning after 1975 (the effective date of a statutory change), except for one amendment which applies to "pledges made after September 8, 1980." 45 Federal Register 52373 (August 7, 1980).

3. T.D. 7710 (Final regulations under Code §§ 1402 and 2032A, on material participation for self-employment purposes, and on special use valuation for estate tax purposes). Effective for taxable years beginning after 1973, in the case of the self-employment tax regulations, and for estates of decedents dying after 1976 (the statute's effective date), for the estate tax regulations. 45 Federal Register 50736 (July 31, 1980).

4. T.D. 7709 (Final regulations under Code § 6420, on payment of excise taxes for certain applicators used on farms). Effective for gasoline and special fuels used after March 31, 1979, on farms for farming purposes. 45 Federal Register 49544 (July 25, 1980).

5. T.D. 7708 (Final regulations under Code § 7216, on tax return preparer disclosures). Effective as of January 1, 1972. 45 Federal Register 49547 (July 25, 1980).

6. T.D. 7706 (Final regulations under Code § 412, exception for certain insurance contract plans from the minimum pension plan funding standard rules). Effective for years beginning after 1975, for plans in existence on January 1, 1974, and otherwise effective for plan years beginning after September 2, 1974 (legislation interpreted in regulations was enacted in 1974). 45 Federal Register 47674 (July 16, 1980).

7. T.D. 7705 (Final regulations under Code § 85, on taxation of unemployment compensation benefits). Effective for taxable years beginning after 1978 (the effective date of the statutory change). 45 Federal Register 46069 (July 9, 1980).

8. T.D. 7704 (Final regulations under Code § 954(c)(3), on treatment of certain earnings of controlled foreign insurance companies). Effective, where indicated, for taxable years of controlled foreign corporations beginning after December 31, 1975 (the effective date of the amending statute), and April 23, 1979 (the date the proposed regulations were published in the Federal Register) and for taxable years of U.S. shareholders whose taxable years end with or within those taxable years of the corporations. 45 Federal Register 42606 (June 25, 1980).

9. T.D. 7703 (Final regulations under Code §410, on computation of time for certain pension purposes). Regulations have varying effective dates, the earliest of which, for plans not in existence on January 1, 1974, is plan years beginning after September 2, 1974 (the date of enactment of the interpreted statute). 45 Federal Register 40979 (June 17, 1979).

10. T.D. 7702 (Final regulations under Code § 412(b), on election of alternative amortization funding of certain pension plans). Effective generally for plan years beginning after 1975, but earlier (or later) in the case of some plans, as provided by the 1974 Pension Reform Act. 45 Federal Register 40113 (June 13, 1980).

11. T.D. 7701 (Final regulations under Code § 6302(c), on deposit requirements for certain social security taxes). Effective generally with respect to wages paid after 1980, but the "safehaven" provision for large employers will be effective with respect to wages paid after 1981. 45 Federal Register 39499 (June 11, 1980).

12. T.D. 7700 (Final regulations under Code § 191, amortization of certain certified historic structures). Effective for additions to capital accounts after June 14, 1976, and before June 15, 1981 (the effective date of the interpreted statute). 45 Federal Register 38050 (June 6, 1980).

13. T.D. 7699 (Final regulations under Code §§ 513 and 527, bingo income of certain tax-exempt organizations). Effective for taxable years beginning after 1969 (the date of the statute, amended in 1978, construed in the regulations). 45 Federal Register 33969 (May 21, 1980).

14. T.D. 7698 (Final regulations under Code § 501(c), exemption from taxation of certain cemetary companies and crematoria, and title holding companies). Effective for various taxable years specified in the regulations, including effective for some taxable years beginning after 1970 (the effective date of a statutory change), and for some transactions after July 7, 1975 (the date of proposed regulations). 45 Federal Regulations 33971 (May 21, 1980).

15. T.D. 7696 (Final regulations under Code § 120, application for recognition as a qualified group legal services plan). Effective for notices of application for recognition of the statuts of a qualified group legal services plan, filed after May 29, 1980. 45 Federal Register 28319 (April 29, 1980).

16. T.D. 7695 (Final regulations on rate of compensation paid to an appraiser of property seized and subject to forfeiture). Effective from May 25, 1980. 45 Federal Register 27932 (April 25, 1980).

17. T.D. 7693 (Final regulations under Code § 6103(p), on administrative review of procedures for determination of the failure of a state tax agency to safeguard federal income tax returns). Effective April 18, 1980 (date of publication). 45 Federal Register 26325 (April 18, 1980).

18. T.D. 7692 (Final regulations under Code § 528, tax status of certain homeowners' associations). Effective for taxable years beginning after 1973 (effective date of the statute). 45 Federal Register 26319 (April 18, 1980).

19. T.D. 7691 (Final regulations under Code § 3121, employment taxes on companion sitting placement services). Effective for remuneration received after 1974. 45 Federal Register 24128 (April 9, 1980).

20. T.D. 7689 (Final regulations under Code § 217, on moving expenses of certain members of the armed forces). Effective for taxable years beginning after 1975 (effective date of the statute). 45 Federal Register 20795 (March 31, 1980).

Also, as discussed in the aforementioned conversation, the following is a summary noting the effective dates of the last 12 proposed regulations issued by the Treasury Department.

1. Proposed Regulations under Code § 280A, business use of residence and vacation homes. Effective for taxable years beginning after 1975 (effective date of the statute). (August 7, 1980).

2. Proposed Regulations under Code § 892, defining a net lease for purposes of taxation of foreign governments. Effective with respect to income derived after July 22, 1980 (date of issuance). (July 22, 1980).

3. Proposed Regulations under Code § 501(c)(9), voluntary employee beneficiary associations. Effective generally for taxable years beginning after December 31, 1954 (date of statute), but later in case of some associations. (July 17, 1980).

4. Proposed Regulations under Code § 166, reserve for certain guaranteed debt obligations. Effective for taxable years ending after October 21, 1965 (effective date of applicable statute). (July 11, 1980).

5. Proposed Regulations under Code § 46, impact of FIFO inventory method on the investment tax credit. Effective for taxable years beginning after December 31, 1975 (effective date of statutory change), but amendments under some Acts have later effective dates tied to those statutes. (July 10, 1980).

6. Proposed Regulations under Code §§ 72 and 105, exclusion from income of certain disability payments. Effective for all taxable years beginning after 1976, except as otherwise provided (date of statute). (July 9, 1980).

7. Proposed regulations under Code §§ 6059 and 6692, periodic report of actuaries of pension plans. Effective for plan years beginning after 1975,

with respect to plans in existence on January 1, 1974, and for plan years beginning after September 2, 1974, with respect to other plans (tied to statute). (July 8, 1980).

8. Proposed regulations under Code § 411, coordination of vesting and discrimination requirements for qualified pension and retirement plans. No effective date given. (June 12, 1980). However, this is a modification of proposed regulations, which are expressly effective for plan years beginning 30 days after their publication. (April 9, 1980).

9. Proposed regulations under Code §§ 170A, 301, 312, 341, 453, 751, 1502, and 1254, on treatment of gain from disposition of certain oil, gas, or geothermal properties. Effective in the case of dispositions of oil or gas properties in taxable years ending after 1975, with respect to intangible drilling and devleopment costs paid or incurred after 1975, and, in the case of a disposition of geothermal property, effective with respect to costs for wells commenced on or after October 1, 1978 (tied to statutory changes). (June 11, 1980).

10. Proposed regulations under Code § 217, moving expense deduction for foreign moves and for retirees or decedents who were working abroad. Effective for expenses paid or incurred in taxable years beginning after 1978, and for expenses paid or incurred in years beginning during 1978 for certain taxpayers (keyed to statutory change). (May 22, 1980).

11. Proposed regulations under Code § 6073, time for filing declarations of estimated income tax by farmers, fisherman, and certain nonresident aliens. Effective for taxable years beginning after November 10, 1978, and for certain taxpayer's taxable years beginning after 1976 (tied to statutes). (May

21, 1980).

12. Proposed regulations under Code § 50A and 50B, work incentive program tax credits. Effective for WIN expenses paid or incurred after 1978, in taxable years ending after such date, with certain exceptions (tied to the statute). (April 30, 1980).

Howard M. Zaritsky

Howard M. Zaritsky
Legislative Attorney

B. INTERNAL REVENUE CODE SECTION 892; PROPOSED IRS REGULATION 1.892–1 (8/15/78); AND FINAL IRS REG. 1.892–1 (7/22/80)

SEC. 892. INCOME OF FOREIGN GOVERNMENTS AND OF INTERNATIONAL ORGANIZATIONS.

The income of foreign governments or international organizations received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments or by international organizations, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments or international organizations, or from any other source within the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle.

[4830-01]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

[26 CFR Part 1]

[LR-106-75]

INCOME OF FOREIGN GOVERNMENTS

Notice of Proposed Rulemaking

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the taxation of income of foreign governments. The regulations would provide guidance for taxing foreign sovereigns on their income from commercial activities within the United States.

DATES: Written comments and requests for a public hearing must be delivered or mailed on or before October 16, 1978. The amendments relating to the taxation of income earned by integral parts of a foreign sovereign are proposed to be effective for all taxable years. The amendments relating to the taxation of income earned by controlled entities are proposed to be effective with respect to income earned after [the date these regulations are filed at the FEDERAL REGISTER as a Treasury decision].

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T (LR-106-75), Washington, D.C. 20224.

FOR FURTHER INFORMATION CONTACT:

Anthony Bonanno of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, D.C. 20224, Attention: CC:LR:T, 202-566-3829, not a toll-free call.

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document contains proposed amendments to the income tax regulations (26 CFR Part 1) under section 892 of the Internal Revenue Code of 1954. These amendments are proposed to clarify the regulations and are to be issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).

Section 892 provides in general that income from sources within the United States received by a foreign government is not to be included in gross income and is to be exempt from taxation. Neither section 892 nor the current regulations defines the term "foreign government." For purposes of section 892, a foreign government consists only of integral parts or controlled entities of a foreign sovereign. The proposed regulations generally provide that income derived by a foreign sovereign from commercial activities in the United States is not income of a foreign government for purposes of the exemption provided in section 892.

The proposed regulations provide definitions for the terms "integral part" of a foreign sovereign and "controlled entity" of a foreign sovereign. The proposed regulations further provide guidelines for the determination of what constitutes commercial activities within the United States.

In most respects, the requirements relating to controlled entities parallel the requirements of Rev. Rul. 75-298, relating to certain organizations created by foreign governments that are eligible for the section 892 exemption. The regulations generally required that a controlled entity must be organized under the laws of the foreign sovereign by which it is owned.

The proposed regulations also provide that the income from the de minimis commercial activities of a controlled entity is subject to tax.

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably six copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the FEDERAL REGISTER.

DRAFTING INFORMATION

The principal author of these proposed regulations was Anthony Bonanno of the Legislation and Regulations Division of the Office of the Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulation, both on matters of substance and style.

PROPOSED AMENDMENTS TO THE REGULATIONS

The proposed amendments to 26 CFR Part 1 are as follows:

§ 1.892 [Removed]

PARAGRAPH 1. Section 1.892 is deleted.

PAR. 2. Section 1.892-1 is amended as follows:

1. The title to § 1.892-1 is revised.

2. Paragraph (a) is deleted and in lieu thereof new paragraphs (a) through (i) are added.

3. Paragraphs (b) (1) and (2) are redesignated as paragraphs (a) and (b) respectively of a new § 1.892-2. The amended § 1.892-1 and new § 1.892-2 read as follows:

§ 1.892-1 Income of foreign governments.

(a) *Manner of taxing.*—(1) *In general.* Section 892 provides, in general, that the income of a foreign government from sources within the United States is excluded from gross income and exempt from taxation. Paragraph (b) of this section describes the extent to which either an entity constituting the governing authority of a foreign sovereign or an organization created by a foreign sovereign will be treated as a foreign government for purposes of section 892. To the extent that income is derived by such an entity or organization of a foreign sovereign which does not qualify as a foreign government as defined in paragraph (b) of this section, a foreign sovereign shall be subject to tax on the income in accordance with the rules of this section.

(2) *Foreign government exemption.* The income derived by an integral part or controlled entity of a foreign sovereign from investments in the United States in stocks, bonds, or other domestic securities, owned by such integral part or controlled entity, or from interests on deposits in banks in the United States of moneys belonging to such integral part or controlled entity, or from any other source within the United States, shall generally be treated as income of a foreign government, shall not be included in gross income, and shall be exempt from taxation.

(3) *Foreign government exemption not available.* (i) Amounts derived by a foreign sovereign from commercial activities in the United States is not income of a foreign government for purposes of the exemption from taxation provided in section 892. Such amounts shall be included in the income of the foreign sovereign and taxed under section 881 or 882 (whichever is applicable).

(ii) Income derived by an organization created by a foreign sovereign that does not qualify as a controlled entity of the foreign sovereign under paragraph (b)(3) of this section shall be included in the gross income of the organization and taxed under the provisions of section 11, 1201, 881, or 882 (whichever is applicable).

(iii) Income derived by a controlled entity from commercial activities in the United States even though on a de minimis basis does not qualify as income of the foreign government and shall be included in gross income of the foreign sovereign and taxed under the provisions of section 11, 1201, 881, or 882 (whichever is applicable).

(b) *Foreign government defined.*—(1) *Classes of a foreign government.* For purposes of this section, a foreign government consists only of integral parts or controlled entities of a foreign sovereign.

(2) *Integral part.* An "integral part" of a foreign sovereign is any person, body of persons, organization, agency, bureau, instrumentality, or body, however designated, that constitutes the governing authority of a foreign country that is not engaged in commercial activities in the United States. The net earnings of the governing authority must be credited to its own account or to other accounts of the foreign sovereign, with no portion inuring to the benefit of any private person. It does not include any individual who is a sovereign, official, or administrator

acting in a private or personal capacity.

(3) *Controlled entity.* A "controlled entity" of a foreign sovereign is any organization (including a foreign central bank of issue qualifying under section 895) created by a foreign sovereign that is not an integral part and that meets the following requirements—

(i) It is wholly owned and controlled by a foreign sovereign;

(ii) It is organized under the laws of the foreign sovereign by which it is owned or, if the law of a State of the United States requires, organized under the law of that State;

(iii) Its net earnings are credited either to its own account or to other accounts of the foreign sovereign, with no portion of its income inuring to the benefit of any private person;

(iv) Its assets must vest in the foreign sovereign upon dissolution; and

(v) It does not engage in the United States in commercial activities on more than a de minimis basis.

The term "controlled entity" does not include any entity wholly owned and controlled by more than one foreign sovereign. Thus, a foreign financial organization organized and wholly owned and controlled by several foreign sovereigns to foster economic, financial, and technical cooperation between various foreign nations is not a controlled entity for purposes of this section.

(4) *Political subdivision and transnational entity.* The rules that apply to a foreign sovereign apply to political subdivisions of a foreign country and to transnational entities. A transnational entity is an organization created by several foreign sovereigns that has broad powers over external and domestic affairs of all participating foreign countries stretching beyond economic subjects to those concerning legal relations and transcending state or political boundaries.

(c) *Characterization of activities.*—(1) *Commercial activities.* For purposes of this section, "commercial activities" generally include activities that constitute a "trade or business within the United States" within the meaning of section 864(b). "Commercial activities" also include activities customarily attributable to and carried on by private enterprise for profit in the United States. The commercial character of an activity is determined by reference to a course of conduct or particular transaction rather than by reference to its purpose. The fact that in some instances Federal, State, or local governments of the United States also are engaged in the same or similar activity does not mean that the activity will not be considered commercial. For example, even though the U.S. Government is engaged in the activity of operating a railroad, operating a railroad is a commercial activity.

(2) *Net lease.* Obtaining and holding "net leases" on property is considered to be a commercial activity.

(3) *Certain activities that are not commercial.* The following activities, among others, are not commercial activities—

(i) Investments in the United States in stocks, bonds, or other domestic securities, or the holding of deposits in banks in the United States which produce interest or dividends not effectively connected with the conduct of a trade or business within the United States;

(ii) Performances and exhibitions within the United States devoted to the promotion of the arts by cultural organizations; and

(iii) The mere purchase of goods in the United States for use of the foreign sovereign.

(d) *Other operative sections.* In determining whether income is from sources within or without the United States, see sections 861 through 863 and the regulations thereunder. For purposes of determining whether income is effectively connected with a trade or business, see section 864(c) and the regulations thereunder. For rules with respect to withholding of tax at source under section 1442 in the case of foreign corporations, see § 1.1441-1.

(e) *Accounting rules.*—(1) *Choice of method of accounting.* A foreign sovereign may choose any method of accounting permissible under section 446(c) and the regulations thereunder. Changes in the method of accounting are subject to the requirements of section 446(e) and the regulations thereunder.

(2) *Choice of annual accounting period.* A foreign sovereign may choose its annual accounting period in accordance with section 441 and the regulations thereunder. Changes in the annual accounting period are subject to the requirements of section 442 and the regulations thereunder.

(f) *Filing of returns.* A return with respect to income taxes under subtitle A shall be made by a foreign sovereign, political subdivision, or a transnational entity with respect to all amounts included in gross income under paragraph (a)(3)(i) of this section, and by every controlled entity subject to tax under paragraph (a)(3)(iii) of this section. See section 6012 for other persons required to make returns of income.

(g) *Relationship of section 892 to certain code sections.*—(1) *Section 893.* The term "foreign government" referred to in section 893 (relating to the exemption of compensation of employees of foreign governments) shall have the same meaning as given such term in paragraph (b) of this section.

(2) *Section 895.* A foreign central bank of issue (as defined in § 1.895-1(b)) that fails to qualify for the exemption from tax provided by this section may nevertheless be exempt from tax on the items of income described in section 895. Thus, a foreign central bank of issue that is not wholly owned and controlled by a foreign sovereign, although not qualifying for exemption under this section, may be exempt under section 895 on the items of income enumerated in such section.

(3) *Section 1442.* No withholding is required under section 1442 and § 1.1442-1 in the case of income exempt from taxation and not included in gross income under paragraph (a)(2) of this section.

(h) *Illustrations.* This section may be illustrated by the following examples:

Example (1). For 1979, the Office of the President of a foreign country invests funds from the foreign sovereign's treasury in publicly traded stocks, bonds, and other domestic securities, and interest bearing bank deposits, the income from which is not effectively connected with the conduct of a trade or business within the United States. The Office of the President has also purchased in 1979 a hotel in the United States which is operated by a U.S. agent. Income from its investments that do not constitute commercial activities under paragraph (c)(3)(i) of this section is exempt from taxation pursuant to paragraph (a)(2) of this section. Income derived from the operation of the hotel is subject to tax pursuant to paragraph (a)(3)(i) of this section since the Office of the President is engaged in commercial activities in the United States by reason of its hotel operations. By reason of section 864(c)(3) and § 1.864-4(b), this income is effectively connected for 1979 with the conduct of a trade or business within the United States by the Office of the President and is taxed under section 882.

Example (2). Pursuant to a general agreement on contracts, exchanges, and cooperation between the United States and a foreign country, the State Concert Bureau, a bureau of a foreign sovereign, entered into four separate contracts to be performed in 1979 with a U.S. corporation engaged in the business of promoting international cultural programs. Under the first contract, the State Concert Bureau agreed to send a singer and accompanists on tour for 3 weeks in the United States. Under the second contract, the Bureau agreed to send a conductor on tour for 4 weeks in the United States. Under the third contract, the Bureau agreed to send the State ensemble of folk dance on tour for 5 weeks in the United States. Under the fourth contract, the Bureau agreed to send the State ballet and opera troupe on tour for 6 weeks in the United States. The State Concert Bureau received approximately $80,000 from the performances and from the sale of programs from the tours. During 1979, the income received by the State Concert Bureau is exempt from taxation under paragraph (a)(2) of this section since the activities of the Bureau are not commercial activities under paragraph (c)(3)(ii) of this section. Depending on the facts and circumstances, the State Concert Bureau may be engaged in commercial activities where it receives income from sources within the United States derived from the tour groups' radio or television appearances, motion picture productions, or record and tape recordings.

Example (3). (a) In 1979 a foreign sovereign organizes under its law M Corp. as a wholly owned government corporation under the auspices of the Ministry of Industry and Tourism. M Corp. engages in the purchasing in the United States of grain and other agricultural goods for free distribution to the poor in its foreign country. In addition, when purchases of grain exceed demand in its foreign country (which rarely occurs), M Corp. engages in the sale of the grain in the United States on a de minimis basis. M Corp. also engages in the trading of commodities futures through a resident broker. It does not have an office or other fixed place of business in the United States through which or by the direction of which the transactions in commodities futures are effected. The purchasing and trading activities of M Corp. are not commercial activities under paragraph (c) of this section. M Corp. is a controlled entity under paragraph (b)(3) of this section. Accordingly, the income from these activities derived by M Corp. from sources within the United States is exempt from tax under paragraph (a)(2) of this section. Any income derived by M Corp. from its sale of grain in the United States on a de minimis basis is not considered to be income of a foreign government and is subject to tax pursuant to paragraph (a)(3)(iii) of this section.

(b) The facts are the same as in example (3)(a), except that in 1979, M Corp. opens an office in Washington, D.C., through which transactions of selling commodities futures in the United States are effected. Since M is now considered to be engaged in a trade or business in the United States under section 864, these activities are commercial activities under paragraph (c) of this section. Since M engages in commercial activities on more than a de minimis basis, it is not a controlled entity. M is not entitled to the exemption from tax provided by section 892. Accordingly, M Corp. is taxed under the applicable provisions of sections 881 and 882. In addition, under paragraph (g)(1) of this section, M Corp. is not a foreign government for purposes of section 893.

(i) *Effective date.* The provisions of this section relating to controlled entities are effective with respect to income derived after [the date these regulations are filed at the FEDERAL REGISTER as a Treasury decision].

§ 1.892-2 Income of international organizations.

(a) *Exempt from tax.* * * *

(b) *Income received prior to Presidential designation.* * * *

* * * * *

JEROME KURTZ,
Commissioner of Internal Revenue.

[FR Doc. 78-22734 Filed 8-14-78; 8:45 am]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part I

[T.D. 7707]

Income Tax; Taxable Years Beginning After December 31, 1953; Income of Foreign Governments

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document provides final regulations relating to the taxation of income of foreign governments. These regulations provide guidance for taxing foreign sovereigns on their income from commercial activities within the United States.

EFFECTIVE DATE: The regulations are generally effective for income of a foreign government from commercial activities within the United States derived after July 22, 1980.

FOR FURTHER INFORMATION CONTACT: Donald K. Duffy of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224, Attention: CC:LR:T (LR-106-75), 202-566-4336.

SUPPLEMENTARY INFORMATION:

Background

On August 15, 1978, the Federal Register published proposed amendments to the Income Tax Regulations (26 CFR Part 1) under section 892 of the Internal Revenue Code of 1954 (43 FR 36111). The amendments were proposed to clarify existing regulations which neither define the term "foreign government" nor establish the types of income excluded from gross income and exempted from taxation. The proposed amendments define a foreign government to include only integral parts and controlled entities of a foreign sovereign. The proposed amendments generally provide that income derived by a foreign government from commercial activities in the United States is not income of a foreign government for purposes of the exemption under section 892.

The proposed amendments in effect provide that if a foreign sovereign separately owns and controls an entity which is not an integral part and which does not constitute a "controlled entity", such an entity is taxed on all of its commercial and noncommercial income under appropriate Internal Revenue Code provisions. The amendments define the term "controlled entity", and in most respects the definition parallels the requirements of Rev. Rul. 75-298, 1975-2 C. B. 290, relating to certain organizations created by foreign governments that are eligible for the section 892 exemption.

The Federal Register published a notice of a public hearing on November 6, 1978 (43 FR 51648). The hearing was held on January 23, 1979.

After consideration of all relevant matters presented by interested persons regarding the proposed amendments, they are adopted as revised by this Treasury decision.

This document also reserves paragraph (c)(2)(i)(*d*) and (*e*) of § 1.892-1. These paragraphs will provide rules for determining whether loans or net leases are to be considered investments. A notice of proposed rulemaking is being published contemporaneously with this Treasury decision setting forth those rules.

Distinction Between Integral Parts and Separate Entities

Comments from the public questioned whether it was appropriate to draw a distinction between integral parts and separate entities of a foreign sovereign under § 1.892-1(b) for purposes of the definition of the term "foreign government". Section 1.892-1(b) is revised in the final regulations. The revision places less emphasis on both the form of the entity that exercises foreign governmental authority and the extent of its commercial activity in the United States.

Pension Plans

One comment suggested clarification of the treatment of pension plans for employees of a foreign government.

Final regulations adopt this suggestion and § 1.892-1(b)(4) provides that certain pension plans qualify for the section 892 exemption even though plan assets are segregated in a separate fund or trust.

Effective Date

Several comments suggested that the effective date be completely prospective. Final regulations adopt this suggestion but also provide retroactivity in cases where no adverse tax consequences arise. Rev. Rul. 75-298 will not apply if these regulations apply.

Commercial Activities

The definition of the term "commercial activities" has been revised. The proposed regulations provide that obtaining and holding net leases on property is a commercial activity. This proposed rule with respect to net leases on real property is withdrawn. A further notice of proposed rulemaking relating to these leases is being published contemporaneously with this Treasury decision.

The final regulations rely generally on the character of an activity, rather than on whether or not the income from the activity is effectively connected with the conduct of a trade or business in the United States, in determining that a particular activity is a commercial activity.

Drafting Information

The principal author of these regulations is Jason R. Felton of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations in matters of both substance and style.

Adoption of Amendments to the Regulations

After consideration of all relevant matters presented by interested persons regarding the proposed amendments to the regulations under section 892, the following amendments are hereby adopted:

Paragraph 1. Section 1.892-1 is amended as follows:

1. The title to § 1.892-1 is revised.

2. Paragraph (a) is deleted and in lieu thereof new paragraphs (a) through (h) are added.

3. Paragraphs (b) (1) and (2) are redesignated as paragraphs (a) and (b), respectively, of a new § 1.892-2. The amended § 1.892-1 and new § 1.892-2 read as follows:

§ 1.892-1 Income of foreign governments.

(a) *Manner of taxing*—(1) *In general.* Section 892 provides, in general, that the income of a foreign government from sources within the United States is excluded from gross income and exempt from taxation. Paragraph (b) of this section defines a foreign government. In particular it describes the extent to which either an integral part of a foreign sovereign or an entity created by a foreign sovereign will be treated as a foreign government for purposes of section 892. To the extent that income is derived by such an integral part or entity of a foreign sovereign which does not qualify as a foreign government as defined in paragraph (b) of this section, the income is subject to taxation in accordance with appropriate Internal Revenue Code provisions.

(2) *Foreign government exemption.* The income derived by an integral part or controlled entity of a foreign sovereign from investments in the United States in stocks, bonds, or other securities, owned by such integral part or controlled entity, or from interest on deposits in banks of moneys belonging to such integral part or controlled entity, or from any other investment source within the United States, is generally treated as income of a foreign government, which is not included in gross income and is exempt from taxation.

(3) *Foreign government exemption not available.* (i) Income derived by an integral part or controlled entity of a foreign sovereign from commercial activities in the United States is not income of a foreign government for purposes of the exemption from taxation provided in section 892. These amounts are included in income and taxed under appropriate Internal Revenue Code provisions.

(ii) Income derived by an entity created by a foreign sovereign that does not qualify as a controlled entity of the foreign sovereign under paragraph (b)(3) of this section is included in the gross income of the entity and taxed under appropriate Internal Revenue Code provisions.

(b) *Foreign government defined*—(1) *Classes of a foreign government.* For purposes of this section, a foreign government consists only of integral parts or controlled entities of a foreign sovereign to the extent not engaged in commercial activities in the United States.

(2) *Integral part.* An integral part of a foreign sovereign is any person, body of persons, organization, agency, bureau, fund, instrumentality, or other body, however designated, that constitutes a governing authority of a foreign country. The net earnings of the governing authority must be credited to its own account or to other accounts of the foreign sovereign, with no portion inuring to the benefit of any private person. It does not include any individual who is a sovereign, official, or administrator acting in a private or personal capacity.

(3) *Controlled entity.* An entity which is separate in form from a foreign sovereign or otherwise constitutes a separate juridical entity is a controlled entity if it satisfies the following requirements:

(i) It is wholly owned and controlled by a foreign sovereign directly or indirectly through one or more controlled entities;

(ii) It is organized under the laws of the foreign sovereign by which owned;

(iii) Its net earnings are credited to its own account or to other accounts of the foreign sovereign, with no portion of its income inuring to the benefit of any private person; and

(iv) Its assets vest in the foreign sovereign upon dissolution.

The term "controlled entity" does not include any entity owned and controlled by more than one foreign sovereign. Thus, a foreign financial organization organized and wholly owned and controlled by several foreign sovereigns to foster economic, financial, and technical cooperation between various foreign nations is not a controlled entity for purposes of this section.

(4) *Pension trust.* A pension trust established exclusively for employees, or former employees, of a foreign government is a controlled entity if it meets the following requirements:

(i) The funds that comprise the trust are managed by trustees who are employees of, or persons appointed by the foreign government; and

(ii) The trust forming a part of the pension plan provides for definitely determinable benefits (defined benefit plan) so that it may be concluded that the income of the trust satisifies the obligations of the foreign government to participants under the plan, rather than inuring to the benefit of a private person.

(5) *Political subdivision and transnational entity.* The rules that apply to a foreign sovereign apply to political subdivisions of a foreign country and to transnational entities. A transnational entity is an organization created by more than one foreign sovereign that has broad powers over external and domestic affairs of all participating foreign countries stretching

beyond economic subjects to those concerning legal relations and transcending state or political boundaries.

(c) *Characterization of activities*—(1) *Commercial activities*. Except as provided in paragraph (c)(2) of this section, all activities conducted in the United States which are ordinarily conducted with a view towards the current of future production of income (whether or not such income is from sources within the United States) are commercial activities. For example, leases on real or personal property, other than holding leases described in paragraph (c)(2)(i) of this section, is a commercial activity.

(2) *Activities that are not commercial*.

(i) *Investments*. Investments in the United States in stocks (whether or not a controlling interest investment), bonds, or other securities, loans, net leases on real property, land which is not producing income (other than on its sale or from an investment in net leases on real property), or the holding of deposits in banks are not commercial activities. consideration of all of the facts and circumstances will determine whether an activity with respect to property described in this paragraph (c)(2)(i) constitutes an investment. The following principles apply in making such a determination;

(*a*) An activity undertaken as a dealer will not be an investment for purposes of this paragraph (c)(2)(i).

(*b*) An activity will not cease to be an investment solely because of the volume of transactions of that activity or because of other unrelated activities.

(*c*) Except in the case of holding stock, an activity will not be an investment merely because the income derived from the activity is not effectively connected with the conduct of a trade or business in the United States. For example, a loan made by a bank, loan company, or similar financial business (open in the United States to the general public) does not constitute an investment.

(*d*) [Reserved—Rules for loans]

(*e*) [Reserved—Rules for net leases on real property]

(ii) *Cultural events*. Performances and exhibitions within the United States of amateur athletic events and events devoted to the promotion of tha arts by cultural organizations are not commercial activities.

(iii) *Purchasing*. The mere purchase of goods in the United States for use of the foreign sovereign is not a commercial activity.

(iv) *Activities other than trade or business*. For purposes of this paragraph, a particular activity in the United States that does not constitute the conduct of a trade or business in the United States under section 864(b) will be deemed not to be a commercial activity. This paragraph (c)(2)(iv) does not apply if the activity in any year or period constitutes the conduct of a trade or business in the United States under section 864(b). This paragraph (c)(2)(iv) also does not apply to activities involving real property and leases of personal property.

(v) *Not for profit*. Activities that are not customarily attributable to or carried on by private enterprise for profit in the United States are not commercial activities. The fact thet in some instances, Federal, State, or local governments of the United States also are engaged in the same or similar activity does not mean that the activity is one described in this paragraph (c)(2)(v). For example, even though the United States Government is engaged in the activity of operating a railroad, operating a railroad is not an activity described in this paragraph (c)(2)(v).

(d) *Other operative sections*. In determining whether income is from sources within or without the United States, see sections 861 through 863 and the regulations thereunder. For purposes of determining whether income is effectively connected with a trade or business, see section 864(c) and the regulations thereunder. For rules with respect to withholding of tax at source, see sections 1441 and 1442 and the regulations thereunder. For rules with respect to methods of accounting and accounting periods, see sections 446 and 441, respectively, and the regulations thereunder.

(e) *Filing of returns*. A return with respect to income taxes under subtitle A shall be made by a foreign sovereign, controlled entity, political subdivision, or a transnational entity with respect to certain amounts included in gross income. See section 6012.

(f) *Relationship of section 892 to certain Code sections*—(1) *Section 893*. The term "foreign government" referred to in section 893 (relating to the exemption for compensation of employees of foreign governments) has the same meaning as given such term in paragraph (b) of this section.

(2) *Section 895*. A foreign central bank of issue (as defined in § 1.895-1(b)) that fails to qualify for the exemption from tax provided be this section may nevertheless by exempt from tax on the items of income described in section 895. Thus, a foreign central bank of issue thet is not wholly owned and controlled by a foreign sovereign. although not qualifying for exemption hunder this section, may be exempt under section 895 on the items of income enumerated in that section.

(3) *Section 883(b)*. Section 892 and this section do not limit the exemption provided under section 883(b), relating generally to the exemption of earnings derived by foreign participants from the ownership or operation of communications satellite systems.

(4) *Section 1442*. No withholding is required under sections 1441 and 1442 in the case of income exempt from taxation and not included in gross income under paragraph (a)(2) of this section.

(g) *Illustrations*. This section may be illustrated by the following examples:

Example (1). For 1981, the Office of the President of a foreign country makes investments of funds from the foreign sovereign's treasury in publicly traded stocks, bonds, and other securities, and interest bearing bank deposits. The Office of the President has also purchased in 1981 a hotel in the United States which is operated by a U.S. agent. None of the income from all of these activities inures to the benefit of the President (or any other official of the foreign country) in a private or personal capacity. The sovereign's investment activities do not constitute commercial activities under paragraph (c) of this section because the foreign sovereign has made investments in property described in paragraph (c)(2)(i) of this section. Income from these investments is exempt under paragraph (a)(2) of this section. Income derived from the operation of the hotel is subject to tax since the Office of the President is engaged in commercial activities in the United States by reason of its hotel operations and hence the income therefrom is not income of a foreign government under paragraph (a)(3)(i) of this section. By reason of section 864(c)(3) and § 1.864-4 (b), this income is effectively connected for 1981 with the conduct of a trade or business within the United States by the Office of the President and is taxed under section 882.

Example (2). Pursuant to a general agreement on contracts, exchanges, and cooperation between the United States and a foreign country, the State Concert Bureau, a bureau of a foreign sovereign, entered into four separate contracts to be performed in 1981 with a U.S. corporation engaged in the business of promoting international cultural programs. Under the first contract, the State Concert Bureau agreed to send a singer and accompanists on tour for 3 weeks in the United States. Under the second contract, the Bureau agreed to send a conductor on tour for 4 weeks in the United States. Under the third contract, the Bureau agreed to send the State ensemble of folk dance on tour for 5 weeks in the United States. Under the fourth contract, the Bureau agreed to send the State ballet and opera troupe on tour for 6 weeks in the United States. The State Concert Bureau received approximately $80,000 from the performances and from the sale of programs from the tours. This income is exempt from taxation under paragraph (a)(2) of this section since the activities of the Bureau are not commercial activities under paragraph (c)(2)(ii) of this section. Although the performances themselves do not constitute commercial activities, they do constitute the conduct of a trade or business in the United States. As a result, income derived by the State Concert Bureau from sources within the United States from the tour groups' United States radio or television appearances, or from motion picture productions or record and tape recordings of United States performances does not qualify for the exclusion from commercial activities contained in paragraph (c)(2) of this section.

Example (*3*). In 1981, the Ministry of Culture of foreign country X enters into certain agreements with a U.S. corporation for the television broadcast in the United States of performances by the State ballet troupe during 1981. These performances occur in foreign country X. During 1981, the Ministry of Culture receives $300,000 in royalties and other fees under the terms of the agreement. Since the performances take place outside the United States, and since the activities are not commercial activities under paragraph (c)(2)(iv) of this section, the income from the performances is income of a foreign government and is exempt from taxation under paragraph (a)(2) of this section.

Example (*4*). (a) In 1981, foreign sovereign Y organizes under its law M Corp. as a wholly owned and controlled government corporation under the auspices of the Ministry of Industry and Tourism. M Corp. engages in the purchasing in the United States of grain and other agricultural goods for free distribution to the poor in country Y. In addition, when purchases of grain exceed demand in foreign country Y (which rarely occurs), M Corp. engages in the sale of grain in the United States. M Corp. also engages in the trading of commodities futures (not for its own account) through a resident broker. Foreign sovereign Y and M Corp. do not have an office or other fixed place of business in the United States through which or by the direction of which the transactions in commodities futures are effected. The purchasing and trading activities of M Corp. are not commercial activities under paragraph (c) of this section. M Corp. is a controlled entity under paragraph (b)(3) of this section. Income from these activities derived by M Corp. from sources within the United States is exempt from taxation under paragraph (a)(2) of this section. However, income derived by M Corp. from the sale of grain in the United States is a commercial activity under paragraph (c) of this section unless M Corp. is not engaged in a trade or business in the United States with respect to its sales activities (paragraph (c)(2)(iv) of this section).

(b) The facts are the same as in example (4)(a), except that in 1982, M Corp. opens an office in Washington, D.C., through which transactions of trading in commodities futures in the United States are effected. These activities are commercial activities under paragraph (c)(1) of this section since M Corp. is now considered to be engaged in a trade or business in the United States under section 864. Thus, paragraph (c)(2)(iv) of this section does not apply. Income from these trading activities is not income of a foreign government under paragraph (a)(3)(i) of this section.

(h) *Effective date.* This section applies to income derived by a foreign sovereign after July 22, 1980, unless the sovereign elects to have it apply to income derived before that date.

§ 1.892-2 Income of international organizations.

(a) *Exempt from tax.* * * *

(b) *Income received prior to Presidential designation.* * * *

* * * * *

(Section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805))

Jerome Kurtz,

Commissioner of Internal Revenue.

Approved: July 2, 1980.

Donald C. Lubick,

Assistant Secretary of the Treasury.

[FR Doc. 80-[illegible] Filed 7-17-80; [illegible] pm]

BILLING CODE 4830-01-M

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

Income Tax; Taxable Years Beginning After December 31, 1953; Income of Foreign Governments

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the taxation of income of foreign governments. The regulations provide guidance for determining whether certain income of foreign sovereigns from loans or leases is derived from the conduct of commercial activities in the United States.

DATES: Written comments and requests for a public hearing must be delivered or mailed on or before September 22, 1980. The amendments are proposed to be effective with respect to income derived after July 22, 1980.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T:LR-213-78, Washington, D.C. 20224.

FOR FURTHER INFORMATION CONTACT: Donald K. Duffy of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224, Attention: CC:LR:T (LR-108-75), or call 202-566-4336.

SUPPLEMENTARY INFORMATION:

Background

The Federal Register today published a Treasury decision under section 892 of the Internal Revenue Code of 1954. That Treasury decision generally provides that the income of foreign sovereigns derived from the conduct of commercial activities in the United States is not income of a foreign government for purposes of the exemption under section 892. Commercial activities do not include, among other activities, investment activities which involve the making of loans and the holding of net leases on real property.

These proposed amendments to paragraph (c)(2)(i) of § 1.892-1 establish the circumstances under which the making of loans or the holding of net leases on real property will be considered to be investment activities. The proposed regulations generally provide that the making of loans or the holding of net leases on real property will be considered investment activities provided the amount of interest, rents, or any other payments associated with the loans or leases is not determined in whole or in part by reference to the income or profits of any person. The proposed amendments also establish rules for determining whether the amount of interest, rents, or other payments will be considered to be determined by reference to income or profits.

Comments and Requests for a Public Hearing

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably six copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the Federal Register.

Drafting Information

The principal author of these proposed regulations is Jason R. Felton of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulation, both on matters of substance and style.

Proposed Amendments to the Regulations

The proposed amendments to 26 CFR Part 1 are as follows:

Section 1.892-1 is amended by adding subdivisions (*d*) and (*e*) to paragraph (c)(2)(i) to read as follows:

§ 1.892-1 Income of foreign governments.

* * * * *

(c) *Characterization of activities.* * * *

(2) *Activities that are not commercial.*

(i) *Investments.* * * *

(*d*) A loan made as a private placement by a person other than a bank, loan company, or similar financial business (open to the general public) will generally be considered an investment. In no event, however, will a loan be considered an investment if the amount which may be received or accrued by tha creditor is determined in whole or in part on the income or profits of any person. Whether the amount may be determined in whole or in part on the income or profits of any person (whether or not derived from property secured by the obligation) is made under the principles of paragraph (c)(2)(i)(*e*) of this section. For example, if in accordance with a loan agreement an amount is received or accrued by the creditor with respect to an obligation which includes both a fixed amount of interest and a percentage of the borrower's income or profits, the amount is considered to be based on income or profits.

(*e*) Holding a net lease on real property will be considered an investment only if, during the term of the lease, the lessor bears no burden or risk (other than by noncompliance of a lessee) of any expenses of the property (such as utilities, repairs, maintenance, insurance or taxes) and has no responsibility to manage or otherwise oversee the property, and the amount which may be received or accrued by the lessor does not depend in whole or in part on the income or profits derived by any person from the property. For purposes of this subdivision (i)(*e*), an amount of rent will not be considered to be based on the income or profits of a person solely by reason of being based on a fixed percentage or percentages of receipts or sales (whether or not receipts or sales are adjusted for returned merchandise, or Federal, State, or local sales taxes). For example, where the lease provides for differing percentages of receipts or sales from different departments or from separate floors of a retail store, rent would not be considered to be based on income or profits so long as each percentage is fixed at the time of entering into the lease and a change in such percentage is not renegotiated during the term of the lease (including any renewal periods of the lease) in a manner which has the effect of basing the rent on income or profits. An amount received or accrued as rent which is based on a fixed percentage or percentages of the lessee's receipts or sales reduced by escalation receipts (including those determined under a formula clause) will not be considered to be based on income or profits. Escalation receipts include amounts received by a prime tenant from subtenants by reason of an agreement that rent will be increased to reflect all or a portion of an increase in real estate taxes, property insurance, operating costs of the prime tenant, or similar items customarily included in lease escalation clauses. If property is leased to a tenant under terms other than solely on a fixed sum rental (for example, a percentage of the tenant's gross receipts), and the tenant subleases all or a part of such property under an agreement which provides for a rental based in whole or in part on the income or profits of the sublessee, the entire amount of the rent received from the prime tenant with respect to such property is considered to be based on income or profits. Where in accordance with the tems of an agreement an amount received or accrued as rent may include both a fixed rental and a percentage of all or a portion of the lessee's income or profits, the entire amount is considered to be based on income or profits even though the amount actually received or accrued in a particular year includes only the fixed rental. An amount received or accrued as rent which consists, in whole or in part, of one or more percentages of the lessee's receipts or sales in excess of determinable dollar amounts may be considered not to be based on income or profits, but only if two conditions exist. First, the determinable amounts do not depend in whole or in part on the income or profits of the lessee. Second, tha percentages and the determinable amounts are fixed at the time the lease is entered into and a change in percentages and determinable amounts is not renegotiated during the term of the lease (including any renewal periods of the lease) in a manner which has the effect of basing rent on income or profits. In any event, a net lease on real property will not be considerd an investment if, considering the lease and all the surrounding circumstances, the arrangment does not conform with normal business practice but is in reality used as a means of basing the rent on income or profits.

Jerome Kurtz,

Commissioner of Internal Revenue.

[FR Doc. 80-21987 Filed 7-17-80; [illegible]]

BILLING CODE 4830-01-M

C. SUMMARIES OF CABLES AND DOCUMENTS RELATING TO MIDDLE EAST OPEC GOVERNMENT COMMUNICATIONS TO U.S. GOVERNMENT OFFICIALS RE: SECTION 892 REGULATION

Doc. No. 20

SUMMARY OF DOCUMENT FURNISHED BY
U.S. EXECUTIVE BRANCH AGENCY

A U.S. official made the following comments in October 1978:

1. As Department and Treasury aware, I have discussed matter of proposed regulations under section 892 on numerous occasions in the past month with this Middle Eastern country's financial aides. They confirmed that very senior government officials have taken a personal and active interest in this matter.

2. Obviously, they are not overjoyed at the prospect of being liable for taxes on some of the country's investments in the U.S., especially if liability may be retroactive. Having first made their concerns known to Embassy, they are now working through their bankers. They are probably content to see how this approach fares.

3. We are unlikely to have an easy time making much headway on holding the line on oil prices. Reassuring them about the dollar, given its continuing slide, also will not be easy. Since these issues are much more important to us than proposed regulations under 892, it would be most unfortunate if the "red herring" of 892 regulations spoiled the atmosphere prior to Secretary Blumenthal's visit. This is not in any way meant to argue the merits of proposed section 892 regulations. It is just that their impact, in the context of our relations with this country and important US policy goals, appears untimely.

4. The above suggests that, at a minimum, Treasury should ensure that consideration of final approval of any new 892 regulations is not completed until after the Secretary's visit. Better yet would be progress in the next few weeks in discussions between their U.S. bankers and Treasury leading to some sort of mutually satisfactory solution which, from this country's standpoint, would probably include reduction or elimination of retroactive tax liability, plus perhaps continuation of exemption from taxation of that part of this country's real estate investment which is clearly in "investment" rather than "commercial" category.

Doc. No. 22

SUMMARY OF DOCUMENT FURNISHED BY
U.S. EXECUTIVE BRANCH AGENCY

1. Summary of late 1978 meeting, abroad. Drawing heavily from brief prepared by a New York law firm, senior Middle Eastern government officials expressed view to senior U.S. official that Section 892 specifically excludes all foreign government investment, including real estate investment, from US income tax. They said that proposed new regulations under Section 892 were causing considerable apprehension within their government, that such taxation will extend beyond real estate to other forms of their government's investment in US. They consider matter "highly sensitive" given relation between their government's oil production and investment possibilities. One high official claimed that former Treasury Secretary Simon and Assistant Secretary Parsky in 1976 meeting had assured him that foreign government real estate investment is not subject to US income tax. End Summary.

2. Subject of proposed revision by IRS of Section 892 regulations was prominently raised by host government with senior US official. Their concern extended beyond effect of proposed regulations on their government's real estate investment in US to potential threat of eventual taxation of all forms of their government's investment in US and the consequences of such a policy on their country's oil production.

3. One host government official said proposed US tax revisions which would make his government's investment in real estate taxable were leading to a great uneasiness within his government that this would be first in a series of measures, eventually taxing their other investment in the US. The US official prefaced his reply by noting that he was not completely current on all aspects of proposed new regulations under Section 892, but he was aware of the major elements involved. He emphasized that the revision was definitely not a political move on the part of the US Government, but rather one taken by the Internal Revenue Service. He explained that, like many other US Government bodies, the IRS by statute has considerable autonomy. He did not know the reason for the timing of the proposed revisions. However, he assured their country's official that the extension of taxation of real estate income to taxation of other forms of investment such as stocks, bonds, bank accounts, etc. was definitely not in the cards. The problem involved was the question of the definition of "commerce". Official investments of the portfolio type are definitely not subject to withholding tax. However, it did seem that there was a problem in that it would not be appropriate to have one commercial venture taxable and another identical commercial venture owned by a

foreign government not taxable. The problem thus was to define which investment came under the commercial rubric. He understood that a US bank had been pursuing this matter and that another senior US official, during his upcoming visit, would bring with him a tax expert who could discuss the matter in detail.

4. To this, the foreign government official replied, "I am not looking at the matter from the financial side, but from the oil side. The only incentive we have to produce is that we can use the proceeds to invest--to exchange one asset for another." The oil ministers of the OPEC surplus countries, he said, would come under increasing pressure if they assumed their investments were under pressure. Finance ministers in surplus countries do not necessarily wish to accommodate oil customers if there is no place to invest added income. His country has very good longstanding relationships with many US financial institutions. It does not wish these to change because of Section 892 complications.

5. According to another senior official of this government, not only does his country have to put up with the declining dollar; now it finds itself taxed on the very investments which serve as a justification for oil production. Reading from a detailed brief prepared by a New York law firm, he claimed that the applicable 1918 statute specifically exempted foreign governments from income tax on the income from stocks, bonds, other instruments or quoting directly from the law, income "from any other source." This being the case, he found it incomprehensible that the IRS should now be proposing to tax any form of his government's investment in the United States including real estate investment. Furthermore, if the analogy were accepted that real estate investment was not a "passive" investment, US taxation might extend to other supposedly "non-passive" investments by his country in the US.

6. The US official assured this official that there were no political motives behind proposed IRS regulations regarding Section 892. Another senior US official was very much aware of the problem and would bring with him a tax specialist to discuss the matter with them. Senior US official stated his view that any retroactivity would be extremely undesirable. He was sure that the USG would try to resolve the matter in a way which would cause minimum disruption. US policy is to be as hospitable as possible to foreign investment. It is not in our interest to discourage this country's investment. There was absolutely no expectation on our part that the proposed regulations under Section 892 would lead to an extension of US taxation to foreign government portfolio holdings in stocks and bonds, etc.

7. In another meeting, another official of this government went over by now very familiar ground emphasizing that the 1918 law specifically exempting foreign government income from stocks, bonds, bank accounts and "any other source." His brief cited more than 50 cases from 1913 to the present where the principle on non-taxation of foreign government investment had been upheld. The US official observed that he had seen the brief for the defense but not that for the prosecution. One could not leap to a definitive conclusion from one brief.

8. Another official of this government said that then Treasury Secretary Simon and Assistant Secretary Parsky had given assurances in 1976 that official investment in the United States, including real estate investment, would not be subject to US Government taxation under Section 892. The US official said that he was unaware of the Simon/Parsky conversation but would ask for records on this subject. The US official emphasized that he did not wish this matter to jeopardize our relations with this country. The Internal Revenue Service had considerable autonomy in this matter but we would do whatever we could to resolve the question fairly. He noted that another senior US official would bring with him a senior tax expert to discuss the matter. The law was absolutely clear on stocks and bonds; the only question regarding real estate investment was the definition of commercial activity, which was a technical point.

9. The same official of this government estimated their US real estate investment income tax under the proposed IRS regulations, but said this could probably be whittled down through legal argument. The taxes involved were not that important; the precedent was.

10. In response to the US official's questions, the same foreign government official said that only the US economy is sufficiently large to absorb his country's investments. He stressed the desire to find a friendly locale for long-term equity and said that his government's real estate investment in the United States takes the following forms: (1) direct ownership of office buildings, (2) joint ventures, and (3) portfolio real estate investment. In all cases these investments are managed for his government by banks. The banks have the right to sit on management boards but have not done so to date. The government has no direct representation in management. What concerns his government is the possible extension of definition of commercial into such things as trading in stocks and bonds.

Doc. No. 7

SUMMARY OF DOCUMENT FURNISHED BY
U.S. EXECUTIVE BRANCH AGENCY

Summary: In a philosophical discussion in early 1979 between a US official and a foreign official of a Middle Eastern country, the foreign official expounded some of his views on oil prices and production with particular reference to efforts to encourage a realistic view of the oil supply situation on the part of American officials. He criticized the apparent unwillingness of the USG to understand the requirements of the oil producers. He further expatiated on his philosophy regarding appropriate levels of his country's oil production suggesting that oil production levels could be cut back if the foreign investment climate, particularly in the US, became less hospitable. End Summary

During an hour-long discussion between a US official and a foreign official of a Middle Eastern country, the foreign official unburdened himself of a number of complaints about US attitudes with respect to the oil price situation. He was obviously annoyed because of the US criticism of what the US considers an excessive OPEC oil price rise. He maintained that US officials should have been aware of the pressures in the oil market as a result of outside factors, including the decline of the dollar. He suggested that, when the US is advised of an irreversible trend, it should not press the oil producers to buck this trend which they might only do at great sacrifice politically and financially. He complained that US officialdom, both publicly and privately, insisted on refusing to see the reality of the situation. He claimed that certain Middle East countries could not have limited the price increase for 1979 to 10 percent if they had not offered a "sweetener" in the form of the quarterly increases.

The US official responded by noting he had been aware of their intention to raise the oil price by no less than 10 percent. However, such an increase appeared to the US to be excessive, particularly in the light of the overall world economic situation as well as the US internal position. Certainly, from the domestic political point of view, no US official could endorse a 10 percent increase in the price of such an important world commodity because of the serious impact such an increase would have both on the US and, even more so, on the developing countries which have no oil resources. Given the US global role, the US had a responsibility to them, as well as to its own people, to try its very best to convince the OPEC oil producers to exercise restraint in their price fixing decision. The US regretted very much that it was not successful in this effort, since it believed that the overall impact on the world economy would be distinctly unfavorable.

The foreign official insisted that oil producing countries did recognize their responsibility toward the world economy and claimed their price increases were not unreasonable. He maintained that, if they had taken the Iranian situation fully into account, prices could have been much higher. He then read from a telex citing current spot price bids for various grades and qualities of crude oil. He expected the spot market to climb higher. He noted that the bids completely outran the offers, even at these prices.

The foreign official then delved into his country's philosophy on oil production, indicating that there were two schools of thought on this question. The first he considered too inflexible, i.e., demanding the restriction of oil production to what is actually needed for domestic budgetary and development purposes, while the second school preferred a more flexible policy which would enable his country to maintain its present program of outside investments. He said he was now leaning toward the first because foreign investment opportunities, in his opinion, were becoming more difficult. The US official asked whether the US was covered by his statement on investment opportunities because he believed that investment opportunities in America were quite extensive. The foreign official said that he saw an attitude developing in the US and cited the current IRS proposal to tax real estate investments by foreign governments as one example and the public opposition to purchases of farm land by Europeans as another. He believed that the US public was being excited unnecessarily about investment activities which were negligible in comparison to the size of the US economy and that, as a result, this would lead to legislative proposals to restrict investments. He, himself, was very pessimistic about the investment future in the US.

The US official suggested that he was overly pessimistic. He noted that, in the case of tax on real estate investment, this involved a matter in which American citizens were in fact being discriminated against by having to pay tax on this type of commercial activity while foreign governments went tax free. As he, himself, recognized, the tax cost in this matter would be relatively small and the investment would still continue to be profitable. He thought that it was important to remove these discriminations which incite public reaction and that, once this was done, the investment picture in the US should remain relatively stable. He stressed that, because of the free enterprise system under which the US operates, it is unlikely that such restrictive policies as he feared could develop, since these would run against the grain of all American principles and beliefs in this respect.

The US official believed the foreign official was attempting to suggest in this discussion of oil prices, production and investment policy that, unless the US investment climate remained relatively hospitable, there was a danger that those oil producing countries with large surpluses such as his own would be forced to reduce their oil production in the future to the disadvantage of the large western oil consumers. The reference to the change in the real estate tax regulation was made only in passing, but obviously was on his mind. The US official believed the foreign official was correct in pointing out that there is a body of opinion in his country which favors a limited production program, but, as the demands upon the Government for development and benefits continue to increase, it is unlikely that this opinion will gain ascendancy. Rather, there will be a continued effort to maintain the level of production stationary. The foreign official seemed to be more annoyed by the fact that he was not able to evoke American appreciation of what he considered to be the realities of the situation. He seemed to think that it was possible for US officials to agree with his assessment of the situation at least privately, even though they had to take certain public positions.

Document No. L-7

SUMMARY OF A CABLE CONTAINING A MEMORANDUM OF CONVERSATION

Date: December 1978

From: A US Embassy in a Middle East OPEC Country

Subject: Taxation of Foreign Investment (Section 892): Informal Treasury Meeting with the Financial Advisor to a Middle East OPEC Country

Participants: High Level Treasury Officials and a US Embassy Official and the Financial Advisor to a Middle East OPEC Country

After brief discussion in which a high level Treasury official outlined US views on the outlook for the dollar and the likely sharp decrease in US current account deficit, the financial advisor to a Middle East OPEC Country provided the following on his country's investments and its concern regarding re-interpretation of section 892. The Middle East OPEC country has always been encouraged by US officials to invest in US. Seventy percent of its overall investment is dollar denominated, as is all of its current income from oil sales. Much of latter income is held in US in short term placements, US being only country that can handle such large sums. The Middle East OPEC country also has other investments in the U.S. in real estate amounting to several hundred million. Because of use of mortgages, this in fact represents property holdings about three times the amount of the investments. The Middle East OPEC country prefers to invest in U.S. real estate rather than, for example, in Europe because its return on real investment in the United States is higher than that it would receive in Europe. Taxation of U.S. real estate investment would reduce net return to below that in Europe.

[Remainder of Document Deleted Pursuant to Agreement with Treasury & Procedures Thereunder.]

UNCLASSIFIED SUMMARY
CABLE I
FROM: US EMBASSY
TO: DEPARTMENT OF STATE
SEPTEMBER 1978

SUBJECT: Middle East OPEC Government requests information on proposed IRS regulation change re Section 892 Internal Revenue code exemption.

1. Foreign Government official requested urgent embassy assistance on following matter. He has been advised by U.S. financial institution handling his country's financial affairs in the U.S. of proposed regulation change by IRS concerning exemption allowed to foreign governments under Section 892 of the Internal Revenue code, and Section 1.892-1 of the IRS regulations.

2. He understands change will be effective Oct. 16 and seeks whatever information is available. Chief of Government, according to this official is very concerned that new regulations will be retro-active and involve extensive tax liability on his country's large U.S. holdings.

3. Embassy is unfamiliar with proposed change in regulations. We understand proposed change may seek to restrict scope of the exemption so that it does not apply to income from commercial activities.

4. Please provide whatever information and explanation are available on proposed change by immediate cable.

UNCLASSIFIED SUMMARY
Cable 2
FROM: Department of State
TO: US Embassy
September 1978

SUBJECT: Middle East OPEC Government request for information on proposed IRS regulation change re Section 892 Internal Revenue Code exemption.

1. Embassy may pass following to foreign government official in response to inquiry in previous cable.

2. On August 15, 1978 Department of Treasury and Internal Revenue service published in the "Federal Register" a notice of proposed rule-making concerning Internal Revenue Code Section 892. Code Section 892 provides that the income of foreign governments is exempt from U.S. income tax. The proposed regulations provide that, in general, income of a "foreign government" from sources within the U.S. would be excluded from gross income and exempt from taxation.

3. Of most interest to foreign government official is that proposed regulations also describe extent to which either an entity constituting the governing authority of a foreign sovereign or an organization created by a foreign sovereign is treated as a "foreign government" for purposes of code section 892. In this regard, proposed regulations state that amounts derived by a foreign sovereign from commercial activities in the U.S. would not be considered income of a "foreign government" for section 892 purposes; i.e.: that these amounts would not qualify for exemption. Commercial activities generally include activities that constitute engaging in a trade or business in the U.S.

4. In proposed regulations, certain activities are specifically designated as not commercial: investments in stocks, bonds, domestic securities or holdings of deposits in U.S. banks; performances and exhibitions devoted to promotion of the arts; and mere purchase of goods in U.S. for use of foreign sovereign. Certain other activities are specifically designated as commercial, such as operating a railroad, and obtaining and holding leases on real and personal property.

5. With respect to so-called controlled entities (in effect,

corporations owned by a foreign government), proposed regulations are effective with respect to income derived after regulations become final. With respect to activities undertaken by foreign sovereigns directly, the proposed regulations would apply to all open taxable years (i.e., generally for the past three years).

Comment: In response to foreign government official's concern that new regulations will be retroactive and involve extensive tax liability on his country's large U.S. holdings, you could point out that the regulation would generally only be retroactive to a three-year limit, as the IRS has a statute of limitation. However, if an older tax return is open for some other reason, that tax year could also be included under the proposed regulations.

6. Notice of proposed rule-making asks for written comments to be delivered on or before October 16, 1978. If requested, public hearings will be held.

UNCLASSIFIED SUMMARY
CABLE 3
FROM: US EMBASSY
TO: DEPARTMENT OF STATE
SEPTEMBER 1978

SUBJECT: Middle East OPEC Government's concern over proposed IRS regulation change re Section 892 Internal Revenue code exemption.

Embassy appreciates effort involved in clarifying uncertainty posed in our earlier cable. Question "whether foreign government's real estate trust will be regarded as commercial activity and therefore subject to taxation of income" is of key concern. If detailed response to foreign government official's concerns will require additional time, please provide interim reply by immediate cable with indication of when we might expect to receive answer, so we can assure him information will be forthcoming.

UNCLASSIFIED SUMMARY
CABLE 4
FROM: US EMBASSY
TO: DEPARTMENT OF STATE
SEPTEMBER 1978

SUBJECT: Middle East OPEC Government's concern over proposed IRS regulation change re Section 892 Internal Revenue Code exemption.

1. Ambassador told foreign official his information was that questions re subject pertinent to gov's situation were being actively considered at higher level in Treasury and IRS. Official, who had been delaying call to his government's minister until we had heard from Washington, said he would telephone him immediately concerning this matter.

2. Official expected that minister would raise these questions with Treasury Secretary Blumenthal. Ambassador suggested that perhaps Under Secretary Solomon might be the one to contact since he is probably overseeing these matters.

3. Treasury may therefore expect request from minister to meet with either Blumenthal or Salomon on this subject when he arrives in Washington to attend IMF/IBRD meetings.

UNCLASSIFIED SUMMARY
CABLE 5
FROM: DEPARTMENT OF STATE
TO: US EMBASSY
OCTOBER 1978

SUBJECT: Proposed Regulation Under IRS Code Section 892.

1. Determining effect of the proposed regulations on foreign government's investment in the United States is difficult without specific factual information about the nature of the investments and the legal arrangements under which they are held and managed. Government should pursue this issue with its tax counsel and with the Internal Revenue Service. As explained below, Treasury's involvement will be limited to policy considerations. Comments on the proposed regulations are required by October 16.

2. This cable elaborates on the rationale behind the regulations and describes the avenues which government officials might want to pursue.

3. The proposed regulations have several purposes, among which is to distinguish between income from commercial activity and other income. When engaged in commercial activity, a foreign government or its controlled entities are taxed as if they were private entities. To define "commercial activity," the regulations rely on the phrase "engaged in a trade or business," which is currently used to determine if foreign individuals or corporations are subject to tax on a net or gross income basis. Individuals or corporations which engage in a trade or business are subject to taxation on a net basis, while those not so engaged are subject to taxation on U.S. source income on a gross basis. Generally speaking, income from the holding or leasing of real estate is considered to be income derived from engaging in a trade or business. The regulations are the first public articulation of a U.S. position on the treatment of foreign governments investing directly in the U.S. Separate and "controlled" entities of foreign governments are also the subject of these regulations, but they have been covered in published rulings for many years.

4. The regulations are not retroactive with respect to controlled entities, because they state that while a controlled entity does not lose its overall exemption under Section 892 if it has deminimis U.S. commercial activities, the commercial income is taxable by the United States. Previously, under IRS ruling, the deminimis commercial income was exempt. The regulations are otherwise retroactive, since they do not change an IRS ruling or regulation.

5. We can appreciate the difficulty of possible retroactive tax payments particularly if government never filed tax returns for a number of years of real estate activity in the United States. Foreign government authorities may wish to consult a tax counsel regarding the possibility of submitting their policy-oriented views to IRS and Treasury on the retroactive application of the regulations. Privacy might be protected by having a withholding agent (i.e., the US financial institution trustee), who may also be affected by the retroactive regulation's present his views. These views could, of course, also suggest alternative substantive interpretations of the statute or policy arguments that at least some forms of real estate investment are noncommercial activities. These policy arguments and substantive interpretations should be made formally and would be considered by Treasury in context of the work on the proposed regulations.

UNCLASSIFIED SUMMARY
CABLE 6
FROM: DEPARTMENT OF STATE
TO: US EMBASSY
OCTOBER 1978

SUBJECT: Proposed Regulations Under IRS Code Section 892

Contents of previous cable may be discretely discussed with foreign government officials.

UNCLASSIFIED SUMMARY
CABLE 7
FROM: US EMBASSY
TO: DEPARTMENT OF STATE
OCTOBER 1978

SUBJECT: Proposed Revision of Regulations Under IRS Code Section 892

1. Foreign government official telephoned the ambassador to inform him of latest action with respect to the proposed IRS revision of regulations covering Code Section 892. He expressed his appreciation for the information provided in Department's cable.

2. Foreign government official reported that officials of U.S. financial institution had met with his minister in US and, after consultation by telephone with his government, had decided to submit a memorandum to IRS contesting the legality of the proposed revision and providing technical comments on the subject. In order to protect the privacy of the government, this memorandum would be phrased in general rather than specific terms. (Comment: It may already have been submitted to IRS by now.)

3. Foreign government official also provided information the U.S. financial institution with personal involvement of its chief executive had contacted Carswell and Bergsten at Treasury, This contact, according to foreign official, elicited a promise from the Treasury officials to focus on this matter. Foreign official commented that he held out some hope for his government's position because this matter was now apparently receiving proper attention. He added that, if his government does not succeed in obtaining an exemption from the proposed revised regulations, it will then have to examine the technical aspects of the matter to see how a maximum reduction on the tax levied on their real estate investments can be accomplished.

4. Foreign government official expressed appreciation for the support he had received from the embassy in his government's efforts to clarify this question.

UNCLASSIFIED SUMMARY
CABLE 8
FROM: DEPARTMENT OF STATE
TO: US EMBASSY
OCTOBER 1978

SUBJECT: Proposed Issuance of Regulations Under IRS Code Section 892.

1. Chief legal counsel (not in-house) for US financial institution called on State Department legal official to discuss proposed regulations under Section 892 of Revenue Code. His basic message was that the financial institution he represents and its Middle East client were extremely concerned about the proposed regulations. He left a legal brief arguing that proposed regulation was contrary to law generally, and in any event could not be applied retroactively. He stated that financial institution he represents would also be submitting a legal brief to the IRS.

2. Legal counsel stated that foreign government officials (unidentified) regarded this issue as "a most delicate political matter." He added that senior U.S. official's forthcoming meeting could be extremely unpleasant if IRS proposal was implemented. He further indicated that those officials thought IRS was politically motivated in regard to this proposed regulation.

3. Legal counsel said that he was surprised that higher level attention had not been given to problem in Dept. and Treasury, given strength of foreign government objections. Financial institution he represents, he said, was concerned at the Chief Executive level.

4. Legal counsel did not request any specific action from Legal Bureau or State Dept. generally. We are now considering what role, if any, Dept might play in this complicated question. We would appreciate any embassy comments, particularly regarding depth of foreign government feelings on this issue, and preliminary policy recommendation.

UNCLASSIFIED SUMMARY
CABLE 9
FROM: DEPARTMENT OF STATE
TO: US EMBASSY
OCTOBER 1978

SUBJECT: Senior U.S. Official's Trip Abroad; U.S. Tax Treatment of Middle East OPEC Government's Direct Investment

1. Officials of this foreign government may raise with senior US official issue of proposed IRS regulations concerning taxation of income of foreign governments from investment in United States. Following is background and talking points, which US Embassy in this country may wish to supplement.

2. IRS has proposed new regulations under Section 892 of Internal Revenue Code. Senior US official's party has copy of proposed regulations and Section 892. In summary, Section 892 exempts from taxation income of "foreign governments" from stocks, bonds, bank deposits "or from any other source within the United States." Proposed IRS regulation interprets this exemption to apply only to "passive" income (interest or dividend income) or income from certain governmentally-oriented activities (such as tour of a national ballet company). Income from engaging in a trade or business in the U.S., e.g., ownership of a hotel, office building, or real estate leases would be taxable to foreign government or any of its agencies or subdivisions.

3. Over a number of years foreign government in question has invested in considerable real estate interests in the U.S., acting in part through U.S. financial institution as agent or broker. Apparently assuming Section 892 exemption applied to these investments, foreign government may not have filed income tax returns. Foreign government thus faces potential tax liability going back for all these years, if regulation is finally promulgated as proposed. We do not know amount of investment or tax liability in question.

4. As evident in previous cable, and as Embassy may elaborate, foreign government officials are concerned generally by the reduction in return on investment and particularly by potential application of the proposed regulations to income from past years. U.S. financial institution and its lawyers have argued to Deputy Secretary Carswell and to IRS, and presumably told foreign government officials that Section 892 on its face, could reasonably be interpreted to exempt this foreign government from tax on the income in question. As suggested previous cable, foreign government officials may believe USG has some anti-Arab political motivation in proposing regulation at this time (this is not the case).

5. If foreign government officials raise this issue, you may wish to draw on above background and the following points. Motivation for proposal was in fact desire to clarify application of 892 with respect to all foreign governments. (F.Y.I. Intent generally was to distinguish between "commercial" and "governmental" types of investment) Treasury has provided opportunity for written comments (including those of U.S. financial institution). We understand Treasury intends to hold public hearings in January on the proposed regulation. Regulation would not be promulgated in final form before then. Furthermore, Treasury is aware of foreign governments special concerns, including problem application to last year's income. For this reason we understand U.S. senior official, intends to take U.S. Government tax expert with him on forthcoming trip abroad.

6. Representatives of U.S. financial institution called on Assistant Secretary Katz concerning this issue. They pointed out potential harm to BOP and to U.S.-OPEC relations if this regulation implemented.

UNCLASSIFIED SUMMARY
CABLE 10
FROM: US EMBASSY IN THIRD COUNTRY
TO: DEPARTMENT OF STATE
DECEMBER 1978

The U.S. Ambassador in a third country noted that he had participated in 1975 meetings on investment with officials of a Middle East OPEC country and offered the following recollections:

He stated that at time there was concern among those officials over U.S. press articles portraying Arabs as "buying out" U.S. and they asked what U.S. policy was toward Arab investments. They were told that Arab investments were most welcome. He believe that question of "active" vs "passive" investments also came up in these discussions. Treasury official pointed out, as he recalled, that tax exemption for investments made by government entities applied only to passive investments. He believed that question also arose as to whether that government should continue to invest in real estate in U.S. and whether these investments would be protected from nationalization. Response was that there was no objection to real estate investment where permitted (some states restrict sales of real estate to foreigners) and that U.S. Federal and State laws provide more protection against nationalization, with prompt and adequate compensation in event property taken over, than any other country in world.

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TAGS: EFIN, KU, US,

SUBJECT: COOPER VISIT TO KUWAIT; U.S. TAX TREATMENT OF KUWAIT DIRECT INVESTMENT

15

REF: STATE 266233

1. KUWAITI OFFICIALS MAY RAISE WITH UNDER SECRETARY COOPER ISSUE OF PROPOSED IRS REGULATIONS CONCERNING TAXATION OF INCOME OF FOREIGN GOVERNMENTS FROM INVESTMENT IN UNITED STATES. FOLLOWING IS BACKGROUND AND TALKING POINTS, WHICH AMEMBASSY KUWAIT MAY WISH TO SUPPLEMENT.

2. IRS HAS PROPOSED NEW REGULATIONS UNDER SECTION 892 OF

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INTERNAL REVENUE CODE. UNDER SECRETARY'S PARTY (MORS") HAS COPY OF PROPOSED REGULATIONS AND SECTIOON 892. IN SUMMARY, SECTION 892 EXEMPTS FROM TAXATION INCOME OF "FOREIGN GOVERNMENTS" FROM STOCKS, BONDS, BANK DEPOSITS "OR FROM ANY OTHER SOURCE WITHIN THE UNITED STATES." PROPOSED IRS REGULATION INTERPRETS THIS EXEMPTION TO APPLY ONLY TO "PASSIVE" INCOME (INTEREST OR DIVIDEND INCOME) OR INCOME FROM CERTAIN GOVERNMENTALLY-ORIENTED ACTIVITIES (SUCH AS TOUR OF A NATIONAL BALLET COMPANY). INCOME FROM ENGAGING IN A TRADE OR BUSINESS IN THE U.S., E.G. OWNERSHIP OF A HOTEL, OFFICE BUILDING, OR REAL ESTATE LEASES WOULD BE TAXABLE TO FOREIGN GOVERNMENT OR ANY OF ITS AGENCIES OR SUBDIVISIONS.

3. OVER THE PAST 13 YEARS KUWAITI GOVERNMENT HAS INVESTED IN CONSIDERABLE REAL ESTATE INTERESTS IN THE U.S., ACTING IN PART THROUGH ( ) AS AGENT OR BROKER. APPARENTLY ASSUMING SECTION 892 EXEMPTIOON APPLIED TO THESE INVESTMENTS, KUWAITIS MAY NOT HAVE FILED INCOME TAX RETURNS. KUWAITIS THUS FACE POTENTIAL TAX LIABILITY GOING BACK THIRTEEN YEARS, IF REGULATION IS FINALLY PROMULGATED AS PROPOSED. WE DO NOT KNOW AMOUNT OF INVESTMENT OR TAX LIABILITY IN QUESTION.

4. AS EVIDENT IN REFTEL, AND AS EMBASSY KUWAIT MAY EELABORATE, KUWAITIS ARE CONCERNED GENERALLY BY THE REDUCTION IN RETURN ON INVESTMENT AND PARTICULARLY BY POTENTIAL APPLICATION OF THE PROPOSED REGULATIONS TO INCOME FROM PAST YEARS. ( ) AND ITS LAWYERS HAVE ARGUED TO DEPUTY SECRETARY CARSWELL AND TO IRS, AND PRESUMABLY TOLD KUWAITIS, THAT SECTION ,"., ON ITS FACE, COULD REASONABLY BE INTERPRETED TO EXEMPT KUWAITI GOVERNMENT FROM TAX ON THE INCOME IN QUESTION. A, SUGGESTED REFTEL, KUWAITIS MAY

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BELIEVE USG HAS SOME ANTI-KUWAIT POLITICAL MOTIVATION IN PROPOSINNG REGULATION AT THIS TIME (-HIS IS NOT RPT NOT THE CASE).

5. IF KUWAITIS RAISE THIS ISSUE, YOU MAY WISH TO DRAW ON ABOVE BACKGROUND AND THE FOLLOWING POINTS. MOTIVATION FOR PROPOSAL WAS IN FACT DESIRE TO CLARIFY APPLICATION OF 892 WITH RESPECT TO ALL FOREIGN GOVERNMENTS. (F.Y.I. INTENT GENERALLY WAS TO DISTINGUISH BETWEEN "COMMERCIAL" AND "GOVERNMENTAL" TYPES OF INVESTMENT) TREASURY HAS PROVIDED OPPORTUNITY FOR WRITTEN COMMENTS (INCLUDING THOSE OF). WE UNDERSTAND TREASURY. INTENDS TO HOLD PUBLIC HEARINGS IN JANUARY ON THE PROPOSED REGULATION. REGULATION WOULD NOT BE PROMULGATED IN FINAL FORM BEFORE THEN. FURTHERMORE, TREASURY IS AWARE OF KUWAIT'S SPECIAL CONCERNS, INCLUDING PROBLEM APPLICATION TO LAST YEARS INCOME. FOR THIS REASON WE UNDERSTAND SECRETARY BLUMENTHAL INTENDS TO BRING TREASURY'S DEPUTY ASSISTANT SECRETARY FOR TAX POLICY (EMIL SUNDLE) WITH HIM ON NOVEMBER VISIT TO KUWAIT.

6.) CALLED ON ASSISTANT SECRETARY KATZ CONCERNING THIS ISSUE.) POINTED OUT POTENTIAL HARM TO BOP AND TO U.S.-OPEC RELATIONS IF THIS REGULATION IMPLEMENTED. VANCE

UNCLASSIFIED

UNCLASSIFIED SUMMARY
CABLE
FROM: US EMBASSY
TO: DEPARTMENT OF STATE
MAY 1979

SUBJECT: Bilateral Tax Issues

1. Official of Mideast OPEC Government has expressed to Embassy his concern about two aspects of the proposed guidelines to Section 892 of the Internal Revenue Code, both of which could affect his Government's exemption from taxation on its investments in the U.S. Those regulations raise two questions. (1) They draw a distinction between a government entity which is an integral part of a foreign government, and a separate entity controlled by a foreign government. The significance of the distinction is that a foreign government is taxed on income from commercial activities in the US, but exempt from tax on passive investment income, with each transaction judged separately whereas a separate government controlled entity loses its tax exemption from all its US income if the income from commercial activity is more than a minimal proportion of the total. (2) The second question is whether his government's income from U.S. corporate bonds would be taxed.

2. Official looks forward to discussing these tax issues in detail in meetings with US Treasury officials.

UNCLASSIFIED SUMMARY
CABLE
FROM: US EMBASSY
TO: DEPARTMENT OF STATE
JUNE 1979

SUBJECT: Mideast OPEC Government's Investment Strategy

1. During call on high official of Mideast OPEC Government, he told me his government's investment strategy would continue to feature major concentration in U.S. dollar assets equivalent to 45-65 percent of surplus funds for CY 1979. His Government would also plan to diversify its increased investment in Western Europe, where they would look into admittedly limited opportunities in smaller countries and also a number of good prospects which may be available in a larger one. In this connection, however, there are taxation problems which still need to be ironed out. In major change in investment policy, government would now return to market in a certain European currency from which it had previously withdrawn.

2. In the U.S., Government would expect to move more broadly into industrial projects and investment. In response to my query, official said that freeze on certain investments was still on because of uncertainty as to application of new IRS regulation under Section 892, but would probably be lifted soon. He expected government go ahead with one major investment which looked very promising. However, with respect to other investment, his government, in view of Section 892 uncertainty, will probably establish offshore companies in the Bahamas, etc., similar to those set up by another Mideast government, through which it would conduct realestate investments.

3. I ascertained that official seemed to be less concerned about the added possibility of public disclosure as a result of a broader investment program. He hoped, however, that there would not be any special publicity accorded to his country's investments, information about which would be provided of course, to US authorities. He maintained that previous concern about investment disclosure related more to technical problems involved in the movement of his country's money in the stock market.

4. Official expressed his appreciation of the trust and confidence he had been able to establish with us in dealing with delicate financial matters. I thanked him for his comment and assured him that Embassy wants to remain worthy of his trust and confidence.

5. Government's investment strategy indicates officials' continued faith in investments in US dollar - it appears that the government of this country will possibly have a greater impact in US investment field as it emerges into a less conservative and more extensive investment program. Naturally, if the IRS gives a more favorable interpretation to its revised regulations, the government of this country is likely to invest more in U.S. real estate because of the greater return it would receive.

UNCLASSIFIED SUMMARY
CABLE 11
FROM: US EMBASSY
TO: DEPARTMENT OF STATE
JULY 1979

SUBJECT: Discussions with Middle East OPEC Government Official on Taxation of Foreign Investment and Rosenthal Hearings

1. Embassy officers yesterday briefed foreign government official on upcoming Rosenthal Hearings and on Treasury proposals regarding taxation of foreign investment in U.S. real estate, drawing extensively on points made in Department's cables.

2. Foreign government official, who had just come from meeting with chief of government, expressed concern about effect of Rosenthal hearings. Besides sensationalist publicity in the U.S. press they were likely to lead to equally overblown coverage in local press, and to pressures from those who know nothing about international investment for his government to shift investment out of the United States. In the past few weeks European bankers and others have been flocking to his country urging government to put more money in European countries and Eurodollar accounts. Foreign government official said he has resisted such pressure since he still believes U.S. is the best place for much of his government's long-term investment. However Rosenthal hearings and attendant Brouhaha might lead to move of some of its funds from U.S. into the Eurodollar market.

3. Drawing on Department cable, embassy officer emphasized that Treasury statement would challenge GAO assertions that USG agencies are not justified in withholding data from Congress on details of individual countries investments in the U.S. Foreign government official took point and seemed more concerned by publicity hearings would generate than actual risk of disclosure.

4. Taxation of foreign investment in U.S. real estate (Section 892): Through U.S. financial institution, foreign government official had received Treasury Department May 79 report on taxation of foreign investment in U.S. real estate, but not June 25 statement by Assistant Secretary for Tax Policy Lubick, which embassy officer provided. He added that U.S. manager of his government's real estate investment portfolio in the United States would arrive soon for discussions of what his government should do in response to proposed Treasury changes in taxation of foreign real estate investment.

5. Since 1973, government here has repeatedly expressed sensitivity over divulgence of information on its investments in the United States or calls that such information be divulged. Rosenthal hearings are likely to reinforce feeling of many government officials that this country would get a better return on its one asset, oil, by leaving it in the ground than by producing above the country's needs. Latter course, they are likely to argue, not only leads to real loss through inflation, but also to vituperative and "racist" attacks in the U.S. on the very investment made necessary by oil production above the country's financial needs. Many of this country's officials are especially sensitive to such attacks, believing them to be inspired by anti-Arab sentiments.

6. We would appreciate receiving text of testimony of USG witnesses before Rosenthal committee, with as extensive summaries as possible by wireless file.

SUMMARY OF DOCUMENT FURNISHED BY
U.S. EXECUTIVE BRANCH AGENCY

UNCLASSIFIED SUMMARY
CABLE

NOVEMBER 1979

SUBJECT: Remarks Made by Senior Official of Mideast OPEC Government

1. Embassy officers followed closely the wording of cable from Department in a presentation to Government official of the current status of outstanding bilateral tax issues. Official's general reaction was that there seemed to be no major changes in the US position. Comments on specific issues: (A) Taxation of income derived by foreign governments and government entities: Official acknowledged that a favorable ruling is supposed to be out shortly, but he observed that this has been the case for some time. (B) Taxation of income from investments in US corporate bonds: He gave no indication as to whether his government might seek an IRS ruling. We could only conclude that such a decision would await further consultations among officials.

2. When asked what subjects might be of particular interest to his ministry in discussions with senior U.S. official during his upcoming trip, he mentioned the effects of fluctuations in the dollar's value on his government's financial resources. He doubted that the Minister would raise tax issues, because "there is nothing hanging".

D. DOCUMENTS DESCRIBING EX PARTE AND OTHER CONTACTS BY U.S. REPRESENTATIVES OF MIDDLE EAST OPEC GOVERNMENTS AND TENTATIVE TREASURY RESPONSE TO THEIR REQUESTS

SUMMARY OF TREASURY DEPT. DOCUMENT —
(Country Names Deleted by Treasury)

INFORMATION

SECRETARY MILLER

Nov. 1979

Donald C. Lubick
Assistant Secretary (Tax Policy)

Regulations Under Code Section 892

We have been asked to summarized various countries' requests for changes in the proposed section 892 regulations and the responses that have been given in the draft of the final regulations.

<u>A Middle East OPEC country</u>

The request was made to give separate entities the same treatment as the government acting directly (allow separate entities a transaction-by-transaction exemption rather than an all or nothing approach to the exemption. The regulations take the approach requested.

<u>A Middle East OPEC country</u>

This country made the same request as the Middle East OPEC country referred to above. The regulations take the approach requested.

<u>A Middle East OPEC country</u>

We were asked to provide that all income of a foreign government is exempt from tax, in particular real estate income and income from net leases. The regulations do not adopt this approach. The regulations provide that income from commercial activities (including net lease income) is taxable. This country also requested that the regulations be effective prospectively only. The regulations in final are prospective only in aplication.

<u>A European Country</u>

We were requested to provide that defined benefit pension plans may be treated as controlled entities and eligible for the foreign government exemption. This request is granted. We were also requested to provide that net lease income is exempt. The regulations do not so provide.

<u>Summary</u>

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Concessions are made in the final regulations satisfying most requests. No IRS or Treasury participant in the regulatory process has been prepared to concede that real estate income generally is not commercial and should be exempt. Moreover, all participants agree that, for the reasons set forth in our prior memo to you, net lease income is not exempt. Although the European country's pension plan has some U.S. net lease income, it appears that the principal government investor in U.S. real estate transactions and net lease transactions is a Middle East OPEC country. That country has been on notice since 1975 that its net lease income is taxable.

INFORMATION

Date: NOV 13 1978

MEMORANDUM FOR: SECRETARY BLUMENTHAL

C8

From: Emil M. Sunley /s/ E.M.S.
Acting Assistant Secretary for Tax Policy

Subject: Taxation of Foreign Governments

Don Lubick advised you that we would contact Mr. Haberkern of Milbank, Tweed, Hadley & McCloy to determine the types of activities carried on in this country by foreign governments to which Chase gives investment advice. Mr. Haberkern has told us that two Chase clients (foreign sovereigns) have made investments of the following kinds in the United States:

1. Net leases on real property.

2. Limited partnership interests in partnerships that lease real property.

3. U.S. grantor trusts that lease real property. The trustee uses an independent contractor to manage the real property.

4. Debt and stock of wholly-owned U.S. corporations that acquire real estate. These U.S. corporations have been paying U.S. tax on the real estate income (the admission of U.S. tax liability in this case attributes a high value to form and undercuts the Milbank argument that any income earned by a foreign sovereign is exempt from U.S. tax under section 892).

5. Debt obligations of private investors in connection with the acquisition of real estate with those investors.

XLI	Initiator	Reviewer	Reviewer	Reviewer	Reviewer	Ex. Sec.
Surname	HANNES	ROSENBLOOM				
Initials / Date	/	/	/	/	/	/

6. U.S. grantor trusts holding unimproved land.

The real property that is leased directly and through the trusts and corporations includes office buildings and shopping centers. Mr. Haberkern did not know the total value of the real estate investments.

TREASURY DEPARTMENT

Document No. C-5

SUMMARY OF A MEMORANDUM

Date: Fall 1978

To: A high level Treasury official

From: A high level Tax Policy official

Subject: Taxation of Investments of a Middle East OPEC Country

Several days ago a high level Treasury official and I met with a lawyer representing the US bank which is an investment advisor to the government of the Middle East OPEC country.

The lawyer discussed arguments already submitted to us by his firm with respect to regulations recently proposed under Code section 892. The firm's position is that section 892 exempts from US tax all income derived by a foreign government, whatever the nature of the income. The firm's principal arguments in support of that position and the contrary policy and legal arguments supporting taxing the commercial activities of foreign sovereigns -- the position taken in the proposed regulations -- are reviewed in Attachment A.

The firm also argues that even if the regulations maintain the position of taxing the commercial income of foreign governments, the regulations should not be applied retroactively. It is, in fact, disturbing to envision the prospect of levying taxes back to the original years of the Middle East OPEC country's investments (perhaps as many as 16 years are open because tax returns have not been filed). Apparently, the Middle East OPEC country was shocked when told the amount of its potential retroactive tax liability.

There were two rulings published during the last 60 years (they are no longer in force) which may have led some to believe that there is a broad exemption from tax under section 892. These rulings may provide a basis for the final regulations to be prospective only. There are contrary considerations, however. For example, * * * was informed in 1976 by Treasury and the IRS that the section 892 exemption did not apply to income from real estate and other commercial activities. We will have to consider the retroactivity question carefully with the Internal Revenue Service.

The attorney asked whether the section 892 problem could be resolved prior to your visit to the Middle East OPEC country. The government of the Middle East OPEC country led him to believe there would be an uncomfortable atmosphere if the issues have not been favorably resolved. I informed the attorney that a public hearing will be held on January 23, 1979. This will be announced during the week of October 29, 1978. Treasury is not in a position to take final action on the regulations until some time after the public hearing.

The attorney added that if the US were to tax the Middle East OPEC country's real estate investments, that country would probably liquidate those investments and place its funds elsewhere. I question whether there would be such a disinvestment. First, I am not aware of any developed country that grants an exemption from tax on real estate income. Second, several of the developed countries, particularly those in Western Europe, have narrow exemptions with respect to the income of foreign sovereigns, even in the case of passive income (Attachment B). In comparison, the exemption provided for dividends, interest, royalties and other types of passive income under the US Code and the proposed regulations appear generous. Thus, it may be difficult for the Middle East OPEC country to find a better tax and investment climate that the United States.

The attorney then said that the Treasury really needed new legislation from Congress to cure this problem. As explained in Attachment A, I do not agree with this position. If we did go to Congress, the government of the Middle East OPEC country and other governments would, however, probably be very disappointed by the legislation Congress would enact. The position of taxing foreign sovereigns has received favorable press. I imagine there would be considerable public pressure on Congress to impose taxes on foreign sovereigns, particularly if much of the income appears to be going to OPEC countries. Further, there is currently considerable sentiment in Congress to impose taxes on income from real estate owned by foreigners. The Revenue Act of 1978 was almost enacted with a provision taxing foreign persons owning U.S. farm land. As passed, the legislation requires us to report to Congress on the real estate within six months. In brief, I do not believe Congress would pass legislation to exempt foreign governments from U.S. tax on income from U.S. businesses, real estate or prehaps even certain passive income such as dividends.

We will be contacting the attorney to find out the nature of the Middle East OPEC country's government interests in the United States. The attorney stated that his firm will not appear at the January 23 public hearing because of the Middle East OPEC country's concern for secrecy.

In conclusion, I believe you should make the following points to the government of the Middle East OPEC country during your visit:

(1) The legal arguments made on the Middle East OPEC country's behalf are being studied at the Treasury at the highest levels.

(2) The argument for "prospective-only" application is supported to some extend by two published (but obsolete) IRS rulings. We believe that relief may be available but there are certain problems and we will have to discuss the issue with the Internal Revenue Service.

(3) No final decision on these points will be made until some time after January 23, 1979. On that date there will be a public hearing.

(4) If Treasury had issued "more favorable" regulations Congress would probably have acted. And, we believe Congress would have enacted a narrow exemption because of US internal political considerations (e.g., concerns about foreign ownership of real estate, particularly farm land).

(5) The position taken in the regulations exempts from U.S. tax, dividends, interest, royalties and other passive income. The investment opportunities in the United States with respect to such income are significant.

(6) The exemption given in the regulations is, in comparison to that of many Western European governments, very favorable.

ATTACHMENT A

A law firm has submitted comments on regulations recently proposed under Code section 892. This memorandum reviews the law firm's comments and the broad issue raised by the regulations.

The principal argument in the law firm's comments is that the proposed regulations are not supportable because section 892 on its face exempts from U.S. tax all income derived by a foreign government, whatever the nature of the income. In contrast, the proposed regulations distinguish between a foreign sovereign acting in a governmental capacity (where exemption is to apply) and one acting in a commercial or proprietary capacity (where exemption is not to apply).

The relevant portion of section 892 states than an exemption is given to foreign governments for income received from various passive investments in the United States "...or from any other source within the United States..." (emphasis added). The statute was amended in 1918 to add the underlined phrase. If the phrase is read literally, it might appear that all types of income earned in the United States by a foreign sovereign are exempt from U.S. tax. Under such an interpretation a foreign finance minister could, for example, purchase General Motors, dissolve the corporation, and operate the business with no U.S. tax liability.

That would be a ridiculous result. Those arguing that Congress contemplated such a result bear a heavy burden. The language of the statute does not mandate this result because: (a) the words "from any other source in the United States" are, in context, unclear; and (b) a critical statutory term ("foreign governments") is not defined.

On the first point, one respected commentator has suggested that the "any other" language might be read as "intended only to encompass previously unenumerated types of investment income...." Tillinghast, Sovereign Immunity From the Tax Collector: United States Income Taxation of Foreign Governments and International Organizations; 10 Law and Policy in International Business 495, 506-08, 536-37 (1978).

The regulations, however, focus more on the second point. Section 892 only exempts from tax the income of "foreign governments." A determination must be made as to whether an entity or person is a "foreign government." Legalistic formalities are not very helpful in making such a determination, particularly since different countries have different political systems and legal concepts as well as different notions of what is a governmental function.

The IRS recognized as early as 1920 that a minister of state can be acting in either a personal or governmental capacity. The section 892 exemption applies only in the latter situation. See O.D. 483, 2 C.B. 96 (1920), declared obsolete in Rev. Rul. 68-575, 1968-2 C.B. 603.

Further, the IRS's historical treatment of so-called "separate entities" belonging to a foreign goverment also recognizes that some types of entities cannot qualify as the "foreign government." For the last twenty-six years exemption of such entities has been tied to the commercial-governmental distinction. The section 892 regulations are based squarely on this distinction, but place no emphasis on the form in which a commercial venture is pursued - i.e., whether there exists a "separate entity" or not.

* * * *

In recent years the IRS and Treasury have become aware that foreign governments are engaging in activities far different from those considered in the past and bearing little or no connection to a governmental function. These activities include producing movies, selling broadcasting rights to cultural performances, playing professional hockey games, running a circus, and purchasing shopping centers and other real estate.

We considered asking for legislation to amend section 892 to cure the obvious problem, but upon reflection concluded that legislation was not necessary. Code section 892 only provides an exemption to foreign governments, not to foreign businesses. Seeking legislation would concede a point that we do not believe needs to be conceded.

In reviewing this issue, we concluded that there were two possible legal interpretations of section 892: to allow a foreign sovereign an exemption from tax on income from any activity; or to restrict the exemption to activities that could be viewed as governmental rather than proprietary. The latter course was chosen for the legal and policy reasons given above. It is hard to find a middle ground between the two positions.

The arguments raised in the law firm's comments are not without merit, but we think the proposed regulations have the better of the argument. In general, we agree with Tillinghast that "the Service can and should take steps to see that its interpretation of section 892 ... distinguishes commercial activities which should not ... denying exemption to 'commercial income,' regardless of the status of the income recipient, is ... appropriate" supra, at 535, 536. Of course, we could be wrong. But we have made the judgment that we should not shy away from a court case because the law firm has a respectable argument.

[SUBCOMMITTEE NOTE: The legal brief referred to in this document is omitted, because the same brief is attached to the October 19, 1978, Treasury memo, which immediately follows.]

to files — 5892

Department of the Treas[u]

Office of the Assistant Secreta[ry] for International Affairs

Office of Developing Nations

to Steve Hannes

room ______ date 10/12

Other agencies

On Wednesday, [redacted] called on [redacted] of the State Department Legal Advisor's office to give him the attached brief.

I can give you a read-out on the meeting.

Robert Banque
room 5413
ext. 566-5712

Sec. 892-
LR 106-15
INFORMATION

C3

DEPUTY SECRETARY CARSWELL OCT 19 1978

Donald C. Lubick
Assistant Secretary for Tax Policy

Code Section 892 — The Taxation of Foreign Governments

The law firm of Milbank, Tweed, Hadley and McCloy has submitted comments on regulations recently proposed under Code section 892. It is our understanding that the comments were submitted on behalf of the government of Kuwait and one of its withholding agents, the Chase Manhattan Bank. This memorandum reviews the Milbank comments and the broad issue raised by the regulations.

The principal argument in the Milbank comments is that the proposed regulations are not supportable because section 892 on its face exempts from U.S. tax all income derived by a foreign government, whatever the nature of the income. In contrast, the proposed regulations distinguish between a foreign sovereign acting in a governmental capacity (where exemption is to apply) and one acting in a commercial or proprietary capacity (where exemption is not to apply).

The relevant portion of section 892 states that an exemption is given to foreign governments for income received from various passive investments in the United States"...or from any other source within the United States..." (emphasis added). The statute was amended in 1918 to add the underlined phrase. If the phrase is read literally, it might appear that all types of income earned in the United States by a foreign sovereign are exempt from U.S. tax. Under such an interpretation a foreign finance minister could, for example, purchase General Motors, dissolve the corporation, and operate the business with no U.S. tax liability.

CODE	INITIATOR	REVIEWER	REVIEWER	REVIEWER	REVIEWER	
	XLI					
SURNAME 1g	HANNES	ROSENBLOOM				
INITIAL/DATE	SH 10/13	RR 10/13				

TD-6196 2/75
DEPARTMENT OF THE TREASURY CORRESPONDENCE APPROVAL AND CLEARANCE

That would be a ridiculous result. Those arguing that Congress contemplated such a result bear a heavy burden. The language of the statute does not mandate this result because: (a) the words "from any other source in the United States" are, in context, unclear; and (b) a critical statutory term ("foreign governments") is not defined.

On the first point, one respected commentator has suggested that the "any other" language might be read as "intended only to encompass previously unenumerated types of investment income...." Tillinghast, Sovereign Immunity From the Tax Collector: United States Income Taxation of Foreign Governments and International Organizations, 10 Law and Policy in International Business 495, 506-08, 536-37 (1978).

The regulations, however, focus more on the second point. Section 892 only exempts from tax the income of "foreign governments." A determination must be made as to whether an entity or person is a "foreign government." Legalistic formalities are not very helpful in making such a determination, particularly since different countries have different political systems and legal concepts as well as different notions of what is a governmental function.

The IRS recognized as early as 1920 that a minister of state can be acting in either a personal or governmental capacity. The section 892 exemption applies only in the latter situation. See C.P. 403, 2 C.B. 96 (1920), declared obsolete in Rev. Rul. 68-575, 1968-2 C.B. 603.

Further, the IRS's historical treatment of so-called "separate entities" belonging to a foreign government also recognizes that some types of entities cannot qualify as the "foreign government." For the last twenty-six years exemption of such entities has been tied to the commercial-governmental distinction. The section 892 regulations are based squarely on this distinction, but place no emphasis on the form in which a commercial venture is pursued - i.e., whether there exists a "separate entity" or not.

The Milbank comments argue that two obsolete IRS rulings support the position that section 892 allows a foreign government to engage in any activity and be exempt from U.S. tax. The first ruling (1920) concerns an activity formerly thought to be governmental in nature: shipping. The second ruling (1951) involves a U.S. corporation engaged in what also might have been perceived to be a governmental activity: running a railroad. The rulings do not take the broad position that Milbank would have us adopt. Nor does any other ruling, decision, or legislative statement.

In recent years the IRS and Treasury have become aware that foreign governments are engaging in activities far different from those considered in the past and bearing little or no connection to a governmental function. These activities include producing movies, selling broadcasting rights to cultural performances, playing professional hockey games, running a circus, and purchasing shopping centers and other real estate.

We considered asking for legislation to amend section 892 to cure the obvious problem, but upon reflection concluded that legislation was not necessary. Code section 892 only provides an exemption to foreign governments, not to foreign businesses. Seeking legislation would concede a point that we do not believe needs to be conceded.

In reviewing this issue, we concluded that there were two possible legal interpretations of section 892: to allow a foreign sovereign an exemption from tax on income from any activity; or to restrict the exemption to activities that could be viewed as governmental rather than proprietary. The latter course was chosen for the legal and policy reasons given above. It is hard to find a middle ground between the two positions.

The arguments raised in the Milbank comments are not without merit, but we think the proposed regulations have the better of the argument. In general, we agree with Tillinghast that "the Service can and should take steps to see that its interpretation of section 892 ... distinguishes commercial activities, which should be taxed, from governmental activities which should not .... denying exemption to 'commercial income,' regardless of the status of the income recipient, is ... appropriate" supra, at 535, 536. Of course, we could be wrong. But we have made the judgment that we should not shy away from a court case because Milbank has a respectable argument.

The Milbank comments also argue that the section 892 regulations should not be retroactive. In support of this argument the comments refer to, among other things, the rulings concerning shipping and railroads explained above.

This is not a very strong ground for prospective only application. We understand, however, that if the regulation is retroactive it might be retroactive indefinitely, since certain foreign governments may have never filed income tax returns. The prospect of the regulation being retroactive indefinitely is troubling.

A contrary consideration is that in 1976, withholding agents of [redacted] were specifically advised that the IRS and Treasury [redacted] view that real estate and other commercial activities are taxable and are not exempt under section 892. Thus, we must consider the question of prospective relief (at least prior to 1976) very carefully for taxpayers or withholding agents that had received notice that the exemption of section 892 is restricted to governmental activities and income.

MEMORANDUM

Re: Taxation of the Income
of a Foreign Government

Section 892 of the United States Internal Revenue Code of 1954 provides:

> "The income of foreign governments or international organizations received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments or by international organizations, of from interest on deposits in banks in the United States of moneys belonging to such foreign governments or international organizations, or from any other source within the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle."

Under Proposed Regulations interpreting that Section, which were published on August 15, 1978, 43 Fed. Reg. 36,111 (1978), the United States Internal Revenue Service took the position that income of a foreign sovereign from "commercial activities in the United States" is not income of a foreign government within the meaning of Section 892. _See_ Prop. Reg. § 1.892-1(a)(3)(i).

1. _The Interpretation Proposed by Proposed Treasury Regulation Section 1.892-1 Is Contrary To Section 892 of the Internal Revenue Code of 1954 and Should Not, Therefore, Be Given Effect_.

Section 892 of the United States Internal Revenue Code of 1954 (the "Code") has its origins in Section 30 of the War Revenue Act, ch. 63, 40 Stat. 300, 337 (1917) which section provided that "nothing in Section II of *** [the 1913 Income Tax Act] or in this title, shall be construed as taxing the income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to foreign governments." Early in 1919, the federal income tax law was substantially restated and reenacted in the Revenue Act of 1918, ch. 18, 40 Stat. 1057 (1919). In that Act, the principles announced in Section 30 of the 1917 War Revenue Act were themselves restated and expanded. Section 213 of the Revenue Act of 1918, ch. 18, 40 Stat. 1065-66, provided that the term "gross income" does not include certain specified items, "which shall be exempt from taxation under this title." Among the specified items was "the income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments<u>, or from any</u>

other source within the United States ***". Revenue Act of 1918, § 213(b)(5). (emphasis added) The only significant difference between Section 30 of the 1917 War Revenue Act and Section 213(b)(5) of the Revenue Act of 1918 was the addition of the underscored punctuation and the additional language. According to the committee report on that legislation, H.R. Rep. No. 767, 65th Cong., 2d Sess. (1918), reprinted in 1939-1 C.B. (Pt. 2) 86, 92, the purpose of the 1918 Revenue Act amendment was to exempt all income of foreign governments from federal income tax:

> "Gross income will include the same items of income as are included under the present law, with the following exceptions:
>
> * * *
>
> "(5) Under the present law it is not necessary to include in gross income the income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments. The proposed bill, in addition to providing that the aforementioned income shall not be included in gross income, provides that income of foreign governments from any other source within the United States shall not be so included." (emphasis added)

Language identical to that used in the 1918 Revenue Act appeared in each Revenue Act through the 1938 Revenue Act and in the Internal Revenue Code of 1939.* The 1939 Code was modified in 1945 to include in the exemption international organizations** and, as so modified, was reenacted with slight change in form as Section 892 of the Internal Revenue Code of 1954.

The only reasonable interpretation of Section 213(b)(5), is that income from all sources, commercial and non-commercial, realized by a foreign government is exempt from tax. That conclusion is confirmed both by other provisions of the Revenue Act of 1918 and the continuous interpretation of its provisions by the Internal Revenue Service.

Section 213(b) of the Revenue Act of 1918 itself demonstrates that Congress was aware of the distinction between governmental and commercial activities of a

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* *§213(b)(5), Revenue Act of 1921, ch. 136, 42 Stat. 227, 238 (1921); §213(b)(5), Revenue Act of 1924, ch. 234, 43 Stat. 253, 268 (1924); §213(b)(5), Revenue Act of 1926, ch. 27, 44 Stat. 9, 24; §116(c), Revenue Act of 1928, ch. 852, 45 Stat. 791, 823 (1928); §116(c), Revenue Act of 1932, ch. 209, 47 Stat. 169, 205 (1932); §116(c), Revenue Act of 1934, ch. 277, 48 Stat. 680, 712 (1934); §116(c), Revenue Act of 1936, ch. 690, 49 Stat. 1658, 1689 (1936); §116(c), Revenue Act of 1938, ch. 289, 52 Stat. 447, 498 (1938); §116(c), Internal Revenue Code of 1939, ch. 2, 53 Stat. 1, 48 (1939).

** International Organizations Immunities Act, ch. 652, §4(a), 59 Stat. 669, 670 (1945).

government. In the case of the states and their subdivisions, Section 213(b)(7) of the Revenue Act of 1918 provided an exemption from tax for "income derived from any public utility or the exercise of any essential governmental function and accruing to any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, ***." The distinction between "governmental" and "commercial" made in Section 213(b)(7) and the absence of that distinction in Section 213(b)(5) demonstrates convincingly that, though Congress was aware of the possible distinction, it did not choose to make it with respect to a foreign government. Subsequent Congresses have continued to distinguish between the commercial activities of foreign governments and those of state governments because Section 213(b)(7), like Section 213(b)(5), was carried over to the Internal Revenue Code of 1954 with only slight change. See Code, § 115. Congress having thus clearly refused to distinguish between "governmental" and "commercial" income of a foreign government, the Internal Revenue Service cannot do so now. Cf. Central Illinois Public Service Co. v. United States, 435 U.S. 21 (1978).

Similarly, from the earliest days, the Internal Revenue Service and its predecessors applied the exemption of Section 213(b)(5) to income derived from commercial activities by a foreign government. In a ruling that was substantially contemporaneous with the 1918 Revenue Act, Office Decision 515, 2 C.B. 96 (1920), declared obsolete*, Rev.Rul. 68-575, 1968-2 C.B. 603, 604, the Bureau of Internal Revenue squarely ruled that the exemption extended to "income derived from the operation of vessels":

> "Inasmuch as section 213(b) of the Revenue Act of 1918 expressly provides that the income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to such governments, or from any other source within the United States is exempt from taxation, it is held that a foreign government is not subject to tax on income derived from the operation of vessels owned by such government through its agents in the United States. Neither is the foreign government liable to tax upon the income arising from the operation for its benefit of vessels chartered by it."

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* The procedure of declaring rulings obsolete is a systematic effort on the part of the Internal Revenue Service to identify rulings which are no longer to be considered determinative with respect to future transactions. "The public announcement that a particular ruling is not determinative with respect to future transactions does not necessarily mean that the conclusion or the underlying rationale has no current applicability." Rev. Proc. 67-6, 1967-1 C.B. 576, 578.

Similarly, Office Decision 182, 1 C.B. 90 (1919), declared obsolete, Rev.Rul. 68-575, supra, ruled that a delegation of a foreign government that derived trading profits from sales of raw materials was exempt from tax:

> "Delegates to the United States representing a foreign country in connection with an agreement with the United States Food Administration, whereby flour is furnished to that country, and raw materials are brought to this country and sold, would not be subject to tax with respect to any profits derived from the sale of such products."

Later, the Bureau of Internal Revenue held that Section 213 (b)(5) applied to income derived by a corporation incorporated in the United States, all of the shares of which were owned by the Government of Nicaragua, from the operation of a railroad in Nicaragua:

> "The Department of State, in a letter of June 6, 1930 to the Secretary of the Treasury in further relation to the case, said that--
>
> "The tax is in effect a tax against the Nicaraguan Government since all the stock of the corporation is owned by that Government and the earnings are used for Governmental expenses. In the light of these facts, I concur in your view that the corporate entity of the plaintiff might well be disregarded in favor of the real party in interest.
> This Department would, therefore, be pleased if the Treasury Department should find it possible to grant the claim for a refund."
>
> "The Bureau of Internal Revenue, in deciding to grant the refund to the company, stated:
>
> "The entire overassessments are due to the fact that, after a thorough consideration

> of the taxpayers' manner of organization and mode of operation, it is determined that the corporation is an agency of a foreign government and is exempt from the operation of the Federal revenue laws and the regulations promulgated thereunder, Sections 213(b) (5) and/or 231(12), Revenue Acts of 1918 and 1921." 2 G. Hackworth, Digest of International Law 475-76 (1941).

The conclusion of that ruling, which was that income derived from a railroad owned by foreign government is exempt from federal income tax, was reaffirmed almost 30 years later in I.T. 4082, 1952-1 C.B. 69, declared obsolete, Rev.Rul. 70-293, 1970-1 C.B. 282, 283. Indeed, prior to the publication of Proposed Regulation Section 1.892-1, the Internal Revenue Service had not adopted the position that a foreign government (as opposed to a government-controlled entity with separate juristic personality) is subject to federal income tax on its income from commercial transactions.

Although the wording of the statute itself, as well as the significance of the specific addition by Congress of the "or from any other source" language, should leave no room for doubt as to the plain meaning of the statute, rules of statutory construction support the interpretation applied in this memorandum. Under the case law, a uniform, contemporaneous interpretation by the authorities responsible for enforcement is to be given weight by the courts, since any subsequent reenactment of the statute is considered to be a congressional confirmation of that interpretation. Thus, in National Lead Co. v. United States, 252 U.S. 140, 145-47 (1920) (a case involving drawbacks under the tariff laws), the Supreme Court said:

> "From Edwards v. Darby, 12 Wheat, 206, to Jacobs v. Prichard, 223 U.S. 200, it has been the settled law that when uncertainty or ambiguity, such as we have here, is found in a statute great weight will be given to the contemporaneous construction by department officials, who were called upon to act under the law and to carry its provisions into effect, especially where such construction has been long continued, as it was in this case for almost forty years before the petition was filed. United States v. Hill, 120 U.S. 169.
>
> "To this we must add that the Department's interpretation of the statute has had such implied approval by Congress that it should not be disturbed, particularly as applied to linseed and its products.
>
> "The drawback provision, under which the construction complained of originated, continued unchanged from 1861 until the revision of the statute in 1870, and the Court of Claims finds that the rule for determining the drawback on oil cake was applied during the whole of that period of almost ten years. * * * During all the intervening twenty-four years this rule of the Department with respect to drawbacks had been widely applied to many articles of much greater importance than linseed or its derivatives, and the practice was continued, linseed included after 1894, until the petition in this case was filed. The reenacting of the drawback provision four times, without substantial change, while this method of determining what should be paid under it was being constantly employed, amounts to an implied legislative recognition and approval of the executive construction of the statute, United States v. Philbrick,

> supra; United States v. G. Falk & Brother, 204 U.S. 143, 152; United States v. Cerecedo Hermanos v. Compania, 209 U.S. 337, for Congress is presumed to have legislated with knowledge of such an established usage of an executive department of the Government United States v. Bailey, 9 Pet. 238, 256."

The contemporaneous construction of Section 213(b)(5) that began with Office Decision 182, supra, in 1920, the reenactment by Congress of the exemption at least eleven times after the original contemporaneous construction by the Bureau of Internal Revenue and the subsequent consistent interpretations by the Bureau or its successor up to the time of the present Proposed Regulations present a stronger case than that considered by the Supreme Court in the National Lead case. That is too long standing an expression of Congressional intent and of interpretation by the Internal Revenue Service for the latter to claim at this date that it was, and always has been, in error.

The enactment of the Foreign Sovereign Immunities Act of 1976, Pub. L. No. 94-583, 90 Stat. 2891 (1976) does not change the above conclusion since nothing in that Act purported to deal with the taxation of income derived by a foreign sovereign from United States sources. Absent such express coverage, the 1976 Act cannot affect the long standing exemption in the Code.

2. <u>Retrospective Application of Proposed Regulation Section 1.892-1 to Foreign Governments is Impermissible.</u>.

Assuming *arguendo* that the Proposed Regulations are promulgated notwithstanding their nonconformance to Section 892 of the Code, those regulations nonetheless should be amended so as to apply only prospectively to income from commercial activities derived by a foreign government. The Proposed Regulations in their present form do, by express provision, not apply to income from commercial activities of a "controlled entity" derived before the promulgation of the final regulations, *see* Proposed Regulation § 1.892-1(i). Because of the failure to refer in this provision to income of a foreign sovereign itself, presumably such Proposed Regulations would apply retrospectively to income of a foreign sovereign accruing in all years not barred by the statute of limitations. *See* Treas. Reg. § 301.7805-1(b); Notice of Proposed Rule Making, 43 Fed. Reg. at 36,111, under the caption "Dates". Such retroactive application to a foreign government would clearly be an impermissible abuse of administrative discretion by the Internal Revenue Service.

As set forth above, the Internal Revenue Service has consistently taken the public position from shortly after the enactment of Section 213(b)(5) of the Revenue Act of 1918 to the date of promulgation of Proposed Regulations Section 1.892-1 that foreign governments were exempt from tax on income from all sources, including commercial activities. No published ruling of the Internal Revenue Service between those dates ever took the position, or even hinted, that income from commercial activities of a foreign government itself would be subject to tax. Indeed, the closest the Internal Revenue Service came to indicating that income from commercial activities would be subject to tax at all was in Rev. Rul. 75-298, 1975-2 C.B. 290, clarified, Rev. Rul. 77-41, 1977-1 C.B. 226, whose holding on this point was expressly limited to a "central bank of issue" or "any other organization created by a foreign government".

The Internal Revenue Service itself has recognized in the Proposed Regulation that retrospective application is impermissible to a foreign government-controlled entity, see Proposed Regulation § 1.892-1(i), even though Rev. Rul. 75-298, supra, had previously given warning that such controlled entities may be taxed on other than de minimus amounts of income from commercial activities. In Rev. Rul. 75-298, supra, the Service also recognized, with respect to such government-controlled entities, that retrospective application was impermissible and applied that revenue ruling only prospectively to income earned after the date of announcement of the ruling. Just as retrospective application of that ruling was, and retrospective application of Proposed Regulation Section 1.892-1(i) to government-controlled entities would be inappropriate, so application of the remainder of the Proposed Regulations under Section 892 should, in any event, be prospective only.

In Helvering v. R.J. Reynolds Tobacco Co., 306 U.S. 110 (1939), the Supreme Court dealt with a very analogous change in position by the Internal Revenue Service. In that case, the taxpayer had purchased and later resold on the open market shares of its stock. The applicable Regulations at the time the transactions took place provided that dealings by a corporation in its own stock would be treated as transactions in the corporate capital and, therefore, exempt from tax. After that regulation had been in force for a period of approximately twelve years, the Internal Revenue Service changed its regulations to provide that when a corporation deals in its shares in the same manner as it would deal in the shares of another company, it would be subject to tax on the income so derived. The Commissioner then argued that under that revised regulation, the corporation was subject to tax on the income that it had derived from transactions in its stock, and that that regulation applied retrospectively. The Supreme Court refused to permit such retrospective application.

> "Since the legislative approval of existing regulations by reenactment of the statutory provision to which they appertain gives such regulations the force of law, we think that Congress did not intend to authorize the Treasury to repeal the rule of law that existed during the period for which the tax is imposed. We need not now determine whether, as has been suggested, the alteration of the existing rule, even for the future, requires a legislative declaration or may be shown by reenactment of the statutory provision unaltered after a change in the applicable regulation. As the petitioner points out, Congress has, in the Revenue Acts of 1936 and 1938, retained Section 22(a) of the 1928 Act <u>in haec verba</u>. From this it is argued that Congress has approved the amended regulation. It may be that by the passage of the Revenue Act of 1936 the Treasury was authorized thereafter to apply the regulation in its amended form. But we have no occasion to decide this question since we are of opinion that the reenactment of the section, without more, does not amount to sanction of retroactive enforcement of the amendment, in the teeth of the former regulation which received Congressional approval, by the passage of successive Revenue Acts including that of 1928." 306 U.S. at 116-17.

In view of the repeated positions taken by the Internal Revenue Service that income from commercial activities derived by a foreign government is exempt from tax and in view of the repeated reenactment of the statutory exemptions after those interpretations by the Service, it is clear that under the principles announced in the <u>Reynolds</u> case, retrospective application of Section 892 to income from commercial activities derived by a foreign government would be impermissible.*

This discussion of prospective versus retrospective application of Proposed Regulation Section 1.892-1 is in no way intended to detract from our opinion that the Internal Revenue Service had no authority under existing law to rule that any income of a foreign sovereign from United States sources is subject to federal income tax, prospectively or retrospectively.

3. Taxation of the Income of a Foreign Sovereign is Contrary to the Principles of Public International Law.

It has been an established principle of public international law in the United States ever since the decision of Mr. Chief Justice Marshall in Schooner Exchange v. M'Faddon, 11 U.S. (7 Cranch) 116, 137 (1812) that, by virtue of the "perfect equality and absolute independence of sovereigns, and this common interest impelling them to mutual intercourse", sovereign states are generally immune from exercises of jurisdiction by other sovereign states.

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* The decisions of the Supreme Court in Dixon v. United States, 381 U.S. 68 (1965) and Manhattan General Equipment Company v. Commissioner, 297 U.S. 129 (1936) are not to the contrary. In Dixon v. United States, supra, retrospective application of the change in the regulations was not in issue. Manhattan General Equipment Company v. Commissioner, supra, dealt with a statutory matter rather than a regulatory change.

Id. at 137. That immunity extends to taxation. Thus, in Republic of Argentina v. City of New York, 25 N.Y.2d 252, 303 N.Y.S.2d 644 (1969), the highest court of the State of New York held that the City of New York may not subject to real property taxes premises owned by the Republic of Argentina that were used by the Republic as its consulate, for the reason that the consideration compelling immunity from suit of a sovereign

> "also demands that it be immune from any obligation to support the functioning of another government through the payment of taxes. This thought, too, was well expressed in the Foreign Legation case ([1943] 2 D.L.R., at p. 492): 'As regards taxes * * * they are imposed by the authority of the state, whether immediately, or mediately, through a municipality or other agency. The imposition of a tax presupposes a person from whom, or a thing from which, it is exacted or collected. It does not require much argument to establish that, consistently with the general principles enunciated in the authorities [relating to sovereign immunity from judicial proceedings] already quoted, such an exaction cannot be demanded by one equal sovereignty from another, or from its diplomatic agent; and there is a general acceptance of the view that such tribute is not eligible, consistently with the principles of the law of nations.' (See, also, City of St. John v. Fraser-Brace, 13 D.L.R.2d 177, 192-193, supra; Yin-Tso Hsiung v. Toronto, [1950] 4 D.L.R.209, 212-213, supra.)"

25 N.Y.2d at 263, 303 N.Y.S.2d at 651.

In respect of taxes, those principles do not distinguish between commercial and governmental activities. Thus, the highest court of the State of Kentucky decided in

French Republic v. Board of Supervisors of Jefferson County, 252 S.W. 124 (1923) that the French state tobacco monopoly was exempt from the Kentucky personal property tax on some 4,359 hogsheads of tobacco that were held in Kentucky for ultimate shipment to France. In so concluding that the property was exempt from tax, the court reasoned, inter alia, that

> "[T]axes are imposed on the theory that the taxpayer should pay a portion of the expense incurred in the protection of his person or property, and as applied to ordinary persons and corporations, this principle seems eminently fair and just; but as applied to independent nations it is clearly opposed to the spirit of international amity, which should prompt every nation to guard and protect the personal property of all other nations that happens to be temporarily within its jurisdiction, without levying a tribute for that purpose."

Id. at 125. Similarly, in the case of the Nicaraguan railroad, described supra, the United States Department of State took the position that it would be contrary to the principles of general public international law for the United States to levy an income tax on a railroad corporation wholly owned by the Government of Nicaragua, even though that income was derived from commercial activites.

Though the Foreign Sovereign Immunities Act of 1976 takes the position that the sovereign immunity from legal proceedings that clearly applied at the time of tha tobacco tax and the Nicaraguan railroad tax decisions no longer applies to "commercial activities", the Act did not amend Section 892 of the United States Internal Revenue Code and subject to taxation income of a foreign sovereign from United States sources, whether such income is derived in commercial transactions or otherwise. Moreover, there is a fundamental difference between jurisdiction for purposes of a lawsuit and taxation of the property of a foreign sovereign. Thus, the Attorney General of Massachusetts once opined:

> "For the Commonwealth [of Massachusetts] to impose a tax on the property of any sovereign within its borders would not only be exercising a jurisdiction to interfere with the rights of that sovereign in such property, but would be taking the further step of attempting to impose an obligation upon such sovereign to contribute toward the public expenses of the Commonwealth. It would be asserting a jurisdiction more fundamental in character, even, than judicial jurisdiction."

5 Op. Att'y. Gen. Mass. 445, 446-47 (1920). Accordingly, he held that Massachusette could not impose such a tax.

The judicial jurisdiction covered by the Foreign Sovereign Immunities Act is an entirely different matter from the imposition of taxes. That Act regulates judicial jurisdiction in cases that involve commercial or other private dealings between United States citizens and foreign sovereigns. H.R. Rep. No. 94-1487, 94th Cong., 2d Sess. 6 (1976). As shown in its legislative history, the sole aim of the Act was to provide an accessible forum in which to settle private disputes.

Whether or not the United States chooses to alter its policy of over 60 years standing and to tax the income of a foreign sovereign from so-called "commercial activities in the United States" is a matter for the Congress to determine. Certainly, it is not within the power of the Internal Revenue Service to obliterate an act of Congress and to declare that "income of a foreign sovereign from commercial activities in the United States is not income of a foreign government" for the purposes of the congressionally established exemption.

Milbank, Tweed, Hadley & McCloy

TAX STATUS OF FOREIGN GOVERNMENT REAL ESTATE INVESTMENT

Background

On August 15, 1978 the Department of the Treasury and the Internal Revenue Service published in the Federal Register a Notice of Proposed Rulemaking concerning Internal Revenue Code section 892. Code section 892 provides that the income of foreign governments is exempt from U.S. income tax. The proposed regulations provide that, in general, income of a foreign government from sources within the U.S. would be excluded from gross income and exempt from taxation.

The proposed regulations also describe the extent to which either an entity constituting the governing authority of the foreign sovereign or an organization created by a foreign sovereign will be treated as a "foreign government" for purposes of Code section 892. In this regard, the proposed regulations state that when a foreign sovereign is engaged in commercial activities in the United States it is not considered to be a foreign government for section 892 purposes. Accordingly, income derived from commercial activities does not qualify for exemption under section 892. Commercial activities generally include activities that constitute engaging in a trade or business in the United States.

The proposed regulations state that certain activities are not commercial: investments in stocks, bonds, domestic securities or holdings of deposits in U.S. banks; performances and exhibitions devoted to promotion of the arts; and the mere purchase of goods in the United States for the use of the foreign sovereign. Certain other activities are specifically designated as commercial: operating a railroad and holding net leases on real and personal property. Thus, net leases on real property as well as conventional leases on real property generate taxable income and the section 892 exemption does not apply to such income.

Certain foreign sovereigns, including Kuwait, have objected to the proposed regulations. These sovereigns have acquired real estate in the United States such as shopping centers and commercial office buildings which are leased on a conventional and net lease basis. The foreign sovereigns

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CORRESPONDENCE APPROVAL AND CLEARANCE

claim that income from real estate is exempt from U.S. tax under section 892. Several written comments have been submitted to the Treasury; a public hearing will be held on January 23, 1979.

The arguments of law raised in the written comments are being studied at the highest levels at the Treasury. Consideration is also being given to the question of whether the proposed regulation should be applied retroactively (as drafted the regulation is, in part, retroactive). Apparently certain foreign governments have never filed tax returns and if the regulation is applied retroactively it could create tax liabilities going back, in the case of Kuwait, sixteen years.

Kuwait has stated that it was promised by Secretary Simon and Assistant Secretary Parsky that their real estate investments would not be subject to tax in the United States. Our records contain no evidence that such a commitment was ever made and it is highly unlikely that it would have been made. The parameters of the foreign government exception were carefully examined during Secretary Simon's tenure and it was the position then, as it is now, that commercial activities of foreign sovereigns (including real estate investments) are not eligible for the foreign government exemption of section 892.

INFORMATION

OCT 19 1978

SECRETARY BLUMENTHAL

Donald C. Lubick
Assistant Secretary (Tax Policy)

Proposed Regulations Dealing With Taxation of Commercial Activities of Foreign Governments in the United States

At the ABA Convention in Honolulu David Rockefeller will very likely discuss with you the newly proposed regulations under section 892 of the Internal Revenue Code dealing with U.S. taxation of commercial activities of foreign governments. These regulations provide that exemption will apply only to activities of a foreign sovereign that are not of a commercial nature. The regulations take a comprehensive position on a subject that has not been clearly addressed previously.

Representatives of Chase have submitted a technical memorandum arguing that the regulations are beyond the statutory authorization of section 892. In addition, Mr. Rockefeller will probably argue that the regulations represent unwise policy because they will lead to a significant outflow of capital from the United States.

On the first point, we have carefully reviewed the technical arguments made by Chase. There is an argument to the effect that all income of a foreign sovereign, including income from commercial activities, is exempt from tax. However, there is a stronger argument that the position taken in the regulations is justifiable as a matter of law. Respected commentators have urged in recent years that the IRS issue regulations of precisely this sort.

As a matter of balance of payments policy, the position urged by Chase appears to go too far. It would permit foreign governments to operate United States businesses tax free, competing with taxable United States businesses. This would seem to be too high a

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CORRESPONDENCE APPROVAL AND CLEARANCE

price to pay for balance of payments benefits. Furthermore, although the regulations may have an adverse impact on the present investments of one of Chase's clients, our information indicates that, as a general matter, foreign governments are investing in the United States in a form (stocks and bonds) that would be exempt under the regulations.

The critical point here is that there is no middle ground between what the regulations propose and absolute exemption of foreign governments from taxation of all income. Absolute exemption is not an appropriate tax policy result, is not a policy pursued by other countries, and does not appear to be required by the statute that now exists on the books.

E. MEMORANDA AND OTHER DOCUMENTS CONCERNING TREASURY'S AND IRS' (1) INTERPRETATION OF SECTION 892 AND (2) CONSIDERATION OF REG. 1.892–1

Department of the Treasury
Office of the Assistant Secretary for International Affairs

to Mr. Chlebowski

room: ________ date 1/9/80

Subject: Proposed Section 892 Regulations

I sympathize with Hufbauer's counsel, but I have a feeling that if we maintain too wide an exemption for foreign governments we would risk political reaction on the Hill which would destroy us. Consequently I think I would be prepared to accept Lubick's recommendation.

Attachment

for F. Lisle Widman FLS
Deputy Assistant
Secretary for International
Monetary and Investment
room 3221
phone 566-5232

January 7, 1980

Under Secretary Solomon
Assistant Secretary Bergsten

Gary Hufbauer

Proposed Section 892 Regulations

Like other recent emanations from the Office of Tax Policy, this proposed regulation runs counter to our broader policy interests in the international arena.

[Deletion by Treasury]
* * * *

For many years now, the IRS has tried to narrow the scope of this exemption through rulings and regulations. To this end, distinctions have been made between a government acting in its sovereign capacity (income exempt under §892) and a government acting as an entrepreneur (income not exempt). This basic classification becomes more complex because even normally exempt investment income may become taxable if it is "effectively connected" to a U.S. trade or business.

The thrust of the instant proposed regulation is to further narrow the scope of real estate investment income that would be exempt from withholding tax. Only net-net lease income would be exempt, and then only if not effectively connected with a U.S. trade or business. And only capital gains from the sale of "unproductive" land (no farming, no mining, no real estate development) would be exempt.

[Deletion by Treasury]
* * * * *

More importantly, the proposed regulation will significantly reduce the range of U.S. inflation-proof assets that might be attractive investment vehicles to the Kuwaits and other oil-producing nations. This point is significant if the elasticity of oil supply is at all connected to the opportunity to invest in secure assets, other than gold, which yield a positive real rate of return.

Recommendation: That you ask the Secretary whether this proposed regulation is consistent with his broader policy goals.

Anthony M. Solomon
Under Secretary for Monetary Affairs

November 9, 1978

H. David Rosenbloom
International Tax Counsel

Regulations on Taxation of Foreign Governments

In all likelihood the regulations dealing with the taxation of foreign government income from United States sources will not be applied retroactively. This means that only income, earned after an appropriate cut-off date will be subject to tax -- not that investments prior to the cut-off date will be forever grandfathered. It is not clear what cut-off date or dates would be appropriate. If we chose the date when taxpayers were put on notice, the date might differ from taxpayer to taxpayer and, in some cases, might be a year or more before issuance of the proposed regulations. Nor is it clear that all aspects of the regulations should have the same cut-off date. Controlled corporations deriving substantial business income from the United States might well receive less favorable treatment than the foreign government itself. Kuwait appears to be primarily interested in the latter situation.

The foregoing information is for your information only and not for publication. Nothing will be announced publicly until after the January 23 hearing. Moreover, the foregoing represents only the direction in which the Revenue Service is leaning, not a final decision. If possible, the Service would prefer that nothing be said on this subject, even privately, until after the January hearing.

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Inter-Office Memorandum

Noted by W.M.B.

☐ ACTION ☐ BRIEFING ☐ INFORMATION

Date: August 9, 1978

For: Secretary Blumenthal

From: Anthony M. Solomon

Subject: Taxation of Income of Foreign Governments

In his August 3 memorandum, Don Lubick recommends publication for comment of a proposed regulation which would state that when a foreign sovereign engages in activities "considered commercial" by U.S. standards, it is not exempt from tax.

Although they cannot be certain about it, the staff experts doubt that the application of the proposed ruling would have a major impact on any foreign government. There are in existence various ways of structuring government investments in the United States to avoid a significant tax liability.

Given the sensitivity of the foreign exchange markets, I would not want to convey the impression that the United States was discouraging capital inflows. This would also be a particularly bad time to irritate such major potential government investors as two Middle East OPEC countries. Nevertheless, on the basis of the staff judgment that such effects are unlikely and the fact that this proposal can be presented primarily as a clarification of the existing situation, I am prepared to support Lubick's recommendation.

We do have a safeguard in that there will be an opportunity for public comment before the proposal is finalized.

	Initiator	Reviewer	Reviewer	Reviewer	Reviewer
Surname					
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OS F 10-01.2 (6-77) which replaces OS 3275 which may be used until stock is depleted.

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Richard Fisher
Coordinator for Policy ~~and~~ Planning
(I-St.) C.I.K.
Charles I. Kingson
International Tax Counsel

Oct. 5, 1977

Section 892 and Saudi Arabian Investments

Section 892 of the Internal Revenue Code provides in relevant part that the income of foreign governments shall be exempt from taxation. Internal Revenue Service Rev. Rul. 75-298 set forth criteria under which such income would be exempt. Since that ruling is a published ruling, governments and their tax advisers may rely on it without having to apply individual determinations. In fact, it was directed at the situation of the oil-exporting countries.

The pressure points over the last year have come when the income of the foreign government is more in the nature of a commercial business than an investment. For example, [redacted] wanted a ruling that its income from constructing and leasing real estate in the United States was exempt from tax. The ruling was denied on the ground that [redacted] real estate activities rose to the level of a business. Multinational government organizations, such as the [redacted] were not considered to be a single governmental organization. So far as I know, there has not been a number of ruling requests under section 892 of the Code.

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COMMENTS RECEIVED

LR- 106-75 Page- 1

Name of Taxpayer: Sullivan & Cromwell (Taylor)

Date of Comments: 10-2-78 Date Comments Recd: 10-6-78

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Name of Taxpayer: Milbank, Tween, Hadlwy & McCloy (Haberkern)

Date of Comments: 10-16-78 Date Comments Recd: 10-16-78

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Name of Taxpayer: Hydeman, Mason & Goodell (Mason)

Date of Comments: 10-16-78 Date Comments Recd: 10-18-78

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Name of Taxpayer: Levin & Kanter(Levenfeld)

Date of Comments: 10-13-78 Date Comments Recd: 10-17-78 (

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Name of Taxpayer: District Tech. Coordinator - Austin District

Date of Comments: 10-11-78 Date Comments Recd: 10-14-78

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Name of Taxpayer: American Bar Assn. (Redman & Troyer)

Date of Comments: 10-18-78 Date Comments Recd: 10-24-78

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Name of Taxpayer: Bank of America (Tierney)

Date of Comments: 10-5-78 Date Comments Recd: 10-24-78

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Name of Taxpayer: Arthur Young & Co. (Ettinger)

Date of Comments: 10-27-78 Date Comments Recd: 10-30-78

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Name of Taxpayer: Hydeman, Mason & Goodell (Mason)

Date of Comments: 11/15/78 Date Comments Recd: 11/16/78

Conference Report

In re: <u>Alternative Interpretations Under Section 892</u>

Conferees:

Robert J. Patrick, Jr.
Lawrence B. Gibbs
Charles L. Saunders
David S. Foster
Gary C. Hufbauer
Sigmund J. Liberman
Edmund I. Goldwag
Marcus B. Blumkin
John L. Crawford
Paul L. Miller
Steven P. Hannes
Anthony Bonanno
Kim A. Palmerino

Date Held: December 12, 1975
Place Held: Room 3042
Time Held: 2:00 P.M.

Mr. Gibbs convened the conference by stating that the reason for the meeting was Treasury's rejection of the ruling position adopted with respect to the [redacted] at the prior conference on December 9th. He further related that although the immediate concern was the section 892 request of the [redacted], the overall focal point of the meeting was to discuss the alternative interpretations under section 892 and to formulate a ruling position for Technical until regulations under that section were promulgated.

Copies of the views of T:C:C, CC:LR and MT were circulated and a discussion followed.

Mr. Patrick explained Treasury's views. He was of the opinion that basically there were two approaches to solving the problem. The first was to define the term "foreign government" as that term is used in section 892; the second was to interpret the phrase "from any other source within the U.S." as that phrase is employed in section 892. The discussion centered around the second approach. Treasury was of the opinion that the phrase "from any other source within the U.S." referred to strictly passive investment. Mr. Hannes interjected that from the Committee reports in 1918, it appeared that Congress did not intend to so limit the interpretation.

Conference Report
In re: Alternative Inter-
pretations Under Section 892

Mr. Miller then inquired whether a severing of the income, activity by activity, would be required. Mr. Patrick responded that the "effectively connected" concept under section 864 might provide the answer.

The general consensus of the conferees was that Treasury's interpretation of the phrase "from any other source within the U.S." would not be a solution to the problem. Mr. Crawford mentioned the hazards of litigation as one deterrent to taking this approach.

Mr. Goldwag mentioned that many of the same problems arise in the context of ruling under section 893. Under section 893 it is also necessary to determine whether an employee is employed by a foreign government, and therefore necessary to define "foreign government." Mr. Hannes suggested that taking the approach of defining the term "foreign government" had a legal basis in the law and was bolstered by the State Department's adoption of the restrictive theory of sovereign immunity. Further, such an approach would effectively carry out Treasury's desire to limit the section 892 exemption to passive income by not allowing an exemption for income derived from conducting commercial activities. The result, Mr. Hannes explained, was a workable solution from a legal standpoint as well as from a policy standpoint.

Mr. Liberman was asked for his views on this approach. He responded by stating that although the approach was one which had not been given much consideration in the past, it appeared to be a viable solution.

Mr. Bonanno representing CC:LR stated that the breadth of section 892 permitted almost any interpretation to merit support. However, he was of the opinion that the approach suggested by Mr. Hannes was the one which he personally agreed with.

Mr. Goldwag, summarizing the progress made to this point stated that there were two classes of organizations, those which are separate in form and thus subject to Rev. Rul. 75-298, and those which are an integral part of the government and thus subject to the Hannes approach.

Conference Report
In re: Alternative Inter-
pretations Under Section 892

Mr. Saunders suggested that regulations be drafted to reflect the Service's position on the definition of the term "foreign government", that position now being that only a foreign government acting in its sovereign capacity will be treated as a foreign government for purposes of section 892. A determination that the foreign government is acting in its sovereign capacity shall be made only where its domestic activities are governmental (non-commercial) by United States standards.

Mr. Gibbs stated that the position adopted was acceptable to him as well as to Treasury and that the position should be published as a revenue ruling as quickly as possible in order to establish the Service's position.

Signature of Person Preparing Report: Kim A. Palmerino — Kim A. Palmerino — 12-16-75 Date

Signature of Person Approving Report: (Signed) Lawrence B. Gibbs — Lawrence B. Gibbs, Assistant Commissioner (Technical) — DEC 18 1975 Date

Mr. Parsky August 28, 1975

(Init.) R. J. P.

Mr. Patrick

Sale of U.S. real property by a foreign government

The sale of real property in the United States by a foreign government may be exempt under a general exemption for all foreign investors in the United States on capital gains or may be exempt under the governmental exemption. However, if the sale of the property is effectively connected with the conduct of a trade or business in the United States, the gain would be taxable in the United States.

(1) The Internal Revenue Code exempts all foreign investors from capital gains tax unless the income is connected with a trade or business in the United States or an individual who sells the property is physically present for at least 183 days in the year of sale. The mere holding of real property in the United States is not engaging in trade or business. Generally speaking, mere ownership and rental of property is not engaging in trade or business. However, the active management or the buying and selling of real estate on a repeated basis constitutes engaging in the active conduct of business.

(2) IRS has not determined the extent to which real estate investments are subject to the additional governmental exemption, i.e., are they passive. Clearly anything constituting an active business as described above would not be passive.

While the exact analysis depends on the specific facts and the entity by which the investment is made, the basic conclusion is that the mere ownership of real property not connected with a business in the United States will mean that the government is exempt.

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DEPARTMENT OF THE TREASURY

CORRESPONDENCE APPROVAL AND CLEARANCE

Department of the Treasury
Washington, D.C. 20220

MEMORANDUM

Date: July 16, 1975

To: Commissioner Alexander
Internal Revenue Service

From: Robert J. Patrick, Jr.
International Tax Counsel

Subject: Foreign Practice re Taxation of Foreign Governments

With respect to foreign government practices on taxation of foreign governments, I thought you would be interested in a summary that was prepared at the last meeting of the OECD Fiscal Committee... [Material deleted.]

Canadian authorities have apparently ruled recently that income on at least some OPEC portofolio investments is exempt.

Enclosure

cc: Mr. Lawrence Gibbs

June 30, 1975

Taxation of Foreign Governments by OECD Countries - Poll Taken at Meeting of Committee on Fiscal Affairs, June 27, 1975

The following informal poll was taken at the OECD meeting, most replies were directed to whether governments, as governments, were exempt. It is possible that governments would frequently be entitled to exemptions on another basis that was more broadly applicable, e.g., no withholding on bank deposits, long term bonds, etc.

Australia - In the past, the doctrine of sovereign immunity has been applied liberally to exempt foreign governments from tax. Now, under non-tax investment controls, a foreign government is required to waive sovereign immunity as a condition of investment. It is unclear whether this rule applies to portfolio investments.

Austria - No government exemptions.

Belgium - No government exemptions. Diplomatic immunities are extended to foreign diplomats under the Vienna Convention.

Canada - Not present.

Denmark - Governments are apparently exempt from withholding. No withholding on interest in the case of all non-residents.

Finland - No withholding on interest. Other income is subject to tax.

France - France exempts from tax dividends and interest where the government has less than a 20 percent participation in the payor.

Germany - Unknown (Spokesman suggested no exemption on basis of sovereign immunity, but central banks may be exempt).

Ireland - Representative wasn't sure because he did not know of any foreign government investment in Ireland. There is generally no withholding on dividends.

Italy - No exemptions except where interest is paid on a loan under an economic cooperation agreement with another state.

Japan - Portfolio dividends and interest are free of withholding. Other income is exempt from tax if the investment is on behalf of a government and is of a "governmental nature".

Luxembourg - No government exemptions.

Netherlands - No government exemptions.

New Zealand - Not present.

Norway - No withholding on interest.

Portugal - No government exemptions.

Spain - No government exemptions.

Sweden - Foreign governments are treated as non-resident corporations. There is no withholding on interest, which is the generally applicable rule.

Switzerland - Central banks are exempt on interest income. Otherwise, only diplomatic immunities (with respect to salaries of diplomats) apply.

Turkey - No government exemptions.

United Kingdom

(a) Government securities held by any non-resident is exempt.

(b) There is no withholding on dividends generally, and foreign governments receive a full (refundable) ACT imputation credit. The U.K. accepts as an exempt government whatever entity is chosen by the foreign government to make the investments, even if a similar natio-alized industry in the U.K. is subject to U.K. tax.

(c) Interest held by a foreign government or agency is exempt.

Internal Revenue S' /ice
memorandum

date: May 15, 1975

to: John W. Holt
Director, T:C

RECEIVED
MAY 16 1975
11:15 AM
CORPORATION TAX DIVISION

from: Lawrence B. Gibbs
Assistant Commissioner (T)

subject: Discussion with Fred Hickman and Bob Patrick Concerning Section 892 of the Code

Jack, as you know, section 892 of the Code provides:

> "the income of foreign governments or international organizations received from investments in the United States in stock, bonds, and other domestic securities, owned by such foreign governments or by international organizations, or from interest on deposits in banks in the United States of monies belonging to such foreign governments or international organizations, or from any other source from within the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle".

According to Bob Patrick, various departments in Treasury are apparently advising foreign governments concerning investments in the United States that might or might not come within this language. Specifically, Bob mentioned that Jerry Parsky's organization and Jack Bennett's organization were being called upon from time to time to counsel foreign governments in this regard.

Apparently, Treasury has also been somewhat concerned by several of the recent rulings which we have submitted for publication to them. Finally, Bob indicated that they understand that there is possibly a proposal circulating for a change in rulings position here in Technical.

For all of the above reasons, they would like to come over and have a discussion with us about this general area, the type of questions that are arising in current letter rulings, what our current letter rulings position is, and what changes we are considering in our rulings position.

I ha~~ve suggested to Bob that we meet at 2:00 on Friday, May 2~~3 here in my conference room. I would appreciate ~~it if you could [illegible] background information by [illegible] Friday, May [illegible].~~ Also, I would appreciate it if someone from your staff and someone from the Branch would plan to attend the meeting on Friday, May 23 with the Treasury representatives. Please call Mary and let her know who will be attending from the Branch and Division.

Larry Gibbs

Lawrence B. Gibbs
Assistant Commissioner (Technical)

F. IRS MATERIAL ON A MIDDLE EAST OPEC GOVERNMENT'S 1974 REQUEST FOR REVENUE RULING (#47), TO EXEMPT INCOME EARNED FROM U.S. REAL ESTATE INVESTMENTS, INCLUDING DESCRIPTIONS OF THOSE INVESTMENTS

COMMISSIONER OF INTERNAL REVENUE

Washington, DC 20224

MAY 1 1980

Honorable Benjamin S. Rosenthal
Chairman, Subcommittee on Commerce,
Consumer and Monetary Affairs
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

In response to your letter dated March 21, 1980, regarding your investigation into the operations and activities of Federal agencies in monitoring, reporting on, and analyzing foreign investment in the U.S., we are providing you with the following:

1) Forty-three private letter rulings, from 1973 to present, issued under Section 892 of the Internal Revenue Code. We are not at this time including four private letter rulings which have been issued under this Section and which are now being prepared for publication. We are also not including several private letter rulings the files for which we are still attempting to locate. All of the private letter rulings, whether or not enclosed, are listed in the enclosed inventory of documents.

2) An inventory of documents, from 1973 to present, in the IRS files relating to Section 892, and the rulings and regulations thereunder. We have indicated in an attachment to the inventory which private letter rulings relate to OPEC countries.

Please let me know if we may be of further assistance in this matter.

With kind regards,

Sincerely,

Stanley A. Koppelman
Assistant to the Commissioner

Enclosure

Attachment

The following issued and unissued letter rulings relate to OPEC countries:

1. #22 - A foreign sovereign created an entity and capitalized it. The entity was organized to assist developing countries through extension of development loans. Its investments in the U.S. consisted of deposits in banks and publicly traded bonds. The issue involved applicability of Rev. Rul. 75-298.

2. #25 - A foreign sovereign established a fund which was a juridical person of public law. The fund was organized to employ the sovereign's assets and income thereon in the diversification of the sovereign's economic structure. The investments of the fund were in U.S. obligations and it certified that if it purchased stock or securities, they would be acquired for investment and would be acquired through a nationally recognized exchange. The issue involved the applicability of Rev. Rul. 75-298.

3. #26 - The issues involved in this ruling are explained in Rev. Rul. 77-41, 1977-1 C.B. 226.

Subcommittee Note: revenue ruling at issue; attached material pertains to this ruling.

4. #47 - This ruling involves real estate investments by the foreign sovereign itself, by quasi-governmental agencies, and by privately owned banks. The investments are in the form of what is commonly referred to as a "net lease" and also in the form of leases where active management of the property is necessary. The issue involved whether or not the foreign government itself is accorded a complete exemption under section 892 and, if not, whether the nature of the government's activities lead to a conclusion that the government is not acting in its sovereign capacity and is subject to tax.

5. #53 - This ruling involves an investment agency which is an entity of the sovereign. The investments include U.S. obligations. The investment agency has broad powers to invest in stocks, real estate, etc. The issue involved Rev. Rul. 75-298.

6. #14 - This ruling relates to a fund established by numerous sovereigns. The fund is an international legal entity but not an international organization under section 892. The fund basically serves as a central bank for the sovereigns. The issue involved whether or not the fund, with its broad powers over member sovereigns, could qualify as a "foreign government per se."

(See Instructions ... Reverse)

1a. Name of Taxpayer or Subject (Including the control number, if any)

[redacted] (Control No. 74-11-27832)

2. Related ... se(s)

1b. Name of Tax Practitioner, if any (Including firm name and city)

[redacted]

3. Symbols

T:I:C:3:1

4. Date of Initial Report

[redacted]

5a. Source of Report

Ruling Request ☒ Tech. Advice Request ☐ Other (Specify) ☐

5b. Date Received in Technical (from item 11, Form M-4400)

[redacted]

6. Reason for Significance

The Government of [redacted], through its [redacted], proposes to invest substantial funds in real estate located in the U.S. The Government of [redacted]'s participation in the proposed transaction, the fact that [redacted] is [redacted] and the likelihood that other governments [redacted] will follow suit with American investment, make this matter of international interest.

7. Background and Principal Issue(s) Involved

The Government of [redacted], through its [redacted] ([redacted]) has entered into an agreement with the [redacted] ([redacted]), a privately owned financial institution. [redacted] is to manage and invest the Government funds. [redacted] and [redacted] ([redacted]), a wholly-owned subsidiary of [redacted] formed [redacted], a [redacted] corporation. [redacted] proposes to enter into an agreement with [redacted], whereby [redacted] through a U.S. branch will manage [redacted]'s U.S. investments. The ruling request seeks a determination under section 892 of the Internal Revenue Code of 1954 that the income generated by the funds invested by the Government of [redacted] will be exempt from U.S. taxation.

8. Estimated Completion Date

~~1-24-75~~ 4-14-75

9. Chronology

Date	Significant Development
3-11-75	A conference was held in the National Office at which time additional information was requested from the taxpayer. Specifically, the information requested required copies of [redacted] law and a brief based on that law which could take from four to six weeks to compile. Action on this case has been suspended, pending receipt of the requested information.

Form M-5945 (Rev 6-74)

QWX 3/20/75 RSW ABB 3/20/75 copy to CCA 3/20/75

FORM 1937-A (REV. 9-74) (CARBON ATTACHED VERSION OF FORM 1937)

[redacted]

Attn: [redacted]

Hugo Santora
(202) 566-3501
T:C:C:3:1
23 MAR 1977

Gentlemen:

This is in reply to your letter dated [redacted] wherein you requested a ruling under section 892 of the Internal Revenue Code of 1954.

Pursuant to a telephone conversation between [redacted] and a representative of our office on March 17, 1977, your request for a ruling on the original transaction is hereby withdrawn.

Sincerely yours,

(Signed) John L. Crawford

Chief, Corporation Tax Branch

KAPalmerino/dhj 3-18-77

"This document may not be used or cited as precedent. Section 6110(j)(3) of the Internal Revenue Code."

REFERENCE
INTERNAL REVENUE - TECHNICAL

ROUTINE
INTERNAL REVENUE SERVICE

CODE	INITIATOR	REVIEWER	REVIEWER	REVIEWER	REVIEWER	REVIEWER	REVIEWER
CODE	T:C:C:3:1	T:C:C:3:1					
SURNAME	Palmerino	John L. Crawford by Santora					
DATE	3/18/77	3-18-77					

DEPARTMENT OF THE TREASURY—INTERNAL REVENUE SERVICE CORRESPONDENCE APPROVAL AND CLEARANCE FORM 1937-A (Rev. 9-74)

☆ U.S. GOVERNMENT PRINTING OFFICE: 1975—893-8

Chronology

Date

9-22-75

The taxpayer has submitted information required by Rev. Rul. 75-298. The issues presented are:

(1) Is a "foreign government" subject to the standards of Rev. Rul. 75-298 or is a "foreign government" exempt on its income from any source within the U.S.?

(2) Is income derived from real estate, whether from "net" leases or otherwise, within the scope of passive income as contemplated in Rev. Rul. 75-298?

3/17/77

An adverse ruling had been drafted and forwarded through the "troika" proceeding. Final approval was given by Treasury on March 7, 1977. The taxpayer was subsequently informed of the Service's adverse position and withdrew his ruling request on 3/17/77. A letter was prepared acknowledging the taxpayer's withdrawal. We shall be forwarding memoranda to the appropriate District Directors informing them of our adverse position in this case. The case is expected to close by 3/23/77.

FORM 1937-A (REV. 9-74) (CARBON ATTACHED VERSION OF FORM 1937)

23 MAR 1977

Assistant Regional Commissioner Audit
Western Region

Chief, Corporation Tax Branch
T:C:C:3:1 - KA Palmerino

[redacted]'s request for a ruling under sections 892, 1441 and 1442.

This memorandum is to call your attention to a request for a ruling on behalf of the Government of [redacted]; that the income derived from various real estate investments is exempt from Federal income taxation and withholding pursuant to sections 892, 1441 and 1442 of the Internal Revenue Code of 1954.

This office had ruled that the activities conducted by the Government of [redacted] constituted commercial activities within the meaning of Rev. Rul. 75-298, 1975-2 C.B. 290 and therefore the income derived from such activities was not exempt from tax under section 892 of the Code.

Upon being informed of our decision, the taxpayer formally withdrew his request. Enclosed is a copy of our adverse ruling letter outlining our position in this case.

We intend to publish a revenue ruling reflecting the position taken in the attached letter.

(Signed) John L. Crawford

John L. Crawford

KAPalmerino/dhj 3-18-77

	INITIATOR	REVIEWER	REVIEWER	REVIEWER	REVIEWER	REVIEWER	REVIEWER
CODE	T:C:C:3:1	T:C:C:3:1					
SURNAME	Palmerino	John L. Crawford / Aysantora					
DATE	3/18/77	3-18-77					

DEPARTMENT OF THE TREASURY—INTERNAL REVENUE SERVICE CORRESPONDENCE APPROVAL AND CLEARANCE FORM 1937-A (Rev. 9-74)

U.S. GOVERNMENT PRINTING OFFICE: 1975-893-860

Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Person to Contact: Kim Palmerino

Telephone Number: (202) 566-3483

Refer Reply to: T:C:C:3:1

Date:

[redacted]

Attn: [redacted]

Gentlemen:

This is in response to your request for a ruling dated [redacted], wherein you sought a determination that income earned for the account of the [redacted], an integral part of the Government of [redacted], would to the extent it is from U.S. sources, be exempt from Federal income taxes under section 892 of the Internal Revenue Code of 1954.

The facts relevant to your ruling request are as follows:

[redacted] ('[redacted]') EIN [redacted] is a [redacted] corporation with its principal office at [redacted]. [redacted] files a consolidated Federal income tax return with the Internal Revenue Service Center at [redacted].

[redacted] ('[redacted]') is an international real estate consulting and management service organization organized under the laws of the State of [redacted] and has its principal office at [redacted]. Currently, the activities of [redacted] are awaiting [redacted] approval. Upon receipt of such approval, [redacted] will engage in worldwide operations and join with [redacted] in filing a consolidated tax return at the Internal Revenue Service Center, [redacted]. A taxpayer identification number will be applied for after [redacted]'s activities are approved by the [redacted]

[redacted] ('[redacted]') will be an investment advisory organization that will specialize in real estate investment and will be organized under the

[redacted]

laws of the Country of [redacted]. [redacted] will have 15,000 shares of common stock authorized and outstanding (the only class of stock). [redacted] will own 48% of these shares. The ownership of the remaining 52 percent of [redacted] is discussed in the following paragraph.

The [redacted] Government, through its [redacted], plans to invest substantial funds in real estate located in [redacted]. Such investment activities will be carried out through arrangements with a series of entities. Firstly, the [redacted] has entered into an agreement with [redacted] ("[redacted]"), a financial institution owned by private persons, to provide for the investment and management of government funds. It has been represented that [redacted] has no major shareholder or major group of shareholders employed by the Government of [redacted] nor is [redacted] either directly or indirectly controlled by the Government of [redacted]. Under the agreement, [redacted] is responsible for managing, investing and reinvesting the Government funds and of collecting income therefrom. Not possessing the needed expertise to engage in [redacted] investment activities on its own behalf, [redacted], in conjunction with [redacted], formed [redacted]. [redacted] owns 50 percent of [redacted]'s outstanding stock and three individual investors also hold 2% of the stock in [redacted]. The [redacted] Government insisted that [redacted] have a proprietary interest in the management vehicle to insure close control over the investments made with Government money. [redacted], on the other hand, will engage in consulting and management activities and, therefore, insisted on remaining wholly owned for management control reasons as well as avoidance of conflicts of interest.

After formation of [redacted], [redacted] will enter into a contract with [redacted] that requires the latter to originate and manage various real property and other investments in [redacted]. [redacted] will employ a small staff of investment origination personnel who will actively seek out real property investments in [redacted]. [redacted] will receive fee income consisting of a fixed percentage of the entire portfolio, and a fixed percentage of dispositions out of portfolio. [redacted] will subcontract for real estate technical services on a cost reimbursement basis with [redacted]. [redacted]

[redacted]

will be composed of a small staff that is experienced in real estate appraisal and analysis, underwriting and administration. [redacted] will evaluate and advise [redacted] personnel and will provide all accounting and reporting for [redacted]. [redacted]'s source of gross income for these activities will be dividends received from its 48% equity interest in [redacted] and cost reimbursements based upon actual expenses. Pursuant to the contract between [redacted] and [redacted], [redacted] is responsible solely to [redacted] for the remittance of funds derived from investments made on behalf of [redacted]. Such contract further provides that [redacted] shall delegate all or portions of its duties to [redacted] who in turn will have the right and power to appoint sub-agents. Pursuant to a contract between [redacted] and [redacted], [redacted] is responsible solely to [redacted] for the delivery of funds derived from investments authorized by [redacted]. Additionally, [redacted] may maintain and establish, on behalf of [redacted], one or more bank accounts.

Consequently, [redacted] may remit income as well as cash flow directly to [redacted] unless instructed to retain and reinvest such funds. [redacted] shall then remit such funds to [redacted] or hold such funds on account of [redacted]. Funds awaiting reinvestment will be invested in short term, interest producing assets.

Currently, through [redacted] [redacted] has purchased 10 buildings, the majority of which are located in [redacted]. Title to these properties is held in six instances directly by [redacted] and in another instance by [redacted] as agent for the Government of [redacted]. The remaining three properties are held by [redacted], a [redacted] corporation. All of these acquisitions with the exception of one involve industrial and commercial type buildings subject to what is commonly referred to as a "net" lease. The term "net" lease as used in the preceding sentence means that the lessee must maintain the property (i.e., pay all operating expenses and maintenance costs, including repairs), pay the taxes on the property, and insure the property. With respect to the property not subject to a "net" lease, the lessee is responsible for maintenance and repairs and the Government of [redacted] pays the insurance and taxes. The return accruing to the account of [redacted] is, for the most part, a net return and requires little or no activity on the part of the investor or its agents with regard to the involved items of property.

[redacted]

In addition to the above-mentioned investments, the Government of [redacted] has purchased a multiple residential development located in [redacted]. Title to the property is held by [redacted] as trustee. This investment will not be under a "net" lease but will be actively managed by a management firm who is an independent contractor and who will collect rent and carry on maintenance in return for fees paid by [redacted] in its supervisory capacity. Neither the [redacted] Government through [redacted], [redacted], [redacted] nor [redacted] will actively engage in the management of such real estate. All such management will be carried on by an independent contractor who is subject to U.S. taxes on fees charged to [redacted] for the account of the [redacted] Government.

Additionally, the Government of [redacted] has purchased a one-third interest in a U.S. limited partnership. The partnership owns a large parcel of vacant land which it proposes to sell or lease to others for development. In addition the partnership owns 50 percent of a domestic corporation which intends to develop a portion of the land into a light industrial commercial park.

Other investments are contemplated in short term money market instruments such as corporate notes, U.S. Treasury obligations and banker's acceptances.

Section 892 of the Code provides, in part, that the income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments, or from interest on deposits in banks in the United States of monies belonging to such foreign governments, or from any other sources within the United States, shall not be included in gross income and shall be exempt from Federal income taxation.

In Rev. Rul. 75-298, 1975-2 C.B. 290, the Service took the position that the income received by an organization created by a foreign government, wholly owned and controlled by such government, whose assets and income are derived solely from the foreign government and its investments, and whose net income is credited

[redacted]

either to itself or to the foreign government will be exempt from U.S. taxation under section 892 of the Code provided:

(1) that the organization does not engage in the U.S. in commercial activities on more than a de minimis basis; and

(2) that its investments in the U.S. include only those which produce passive income such as currencies, fixed interest deposits, stocks, bonds, and notes or other securities evidencing loans.

Similarly, the Service takes the view that a foreign government per se (as opposed to an organization within the scope of Rev. Rul. 75-298) will be exempt from U.S. taxation under section 892 of the Code when the income it derives is not considered derived from commercial activities within the U.S.. Activities which constitute a trade or business within the U.S. will be considered to be commercial.

Where the U.S. activities of an integral part of a foreign government produce income which is effectively connected with the conduct of a trade or business within the United States (under the principles of section 1.864-4 of the Income Tax Regulations), that income will be considered to be commercial.

Application of thse principles to the facts in the instant case, yield the following conclusions:

The U.S. activities of the Government of [redacted], imputed to it through the activities of its U.S. agents and independent contractors who, with respect to the aforementioned investments, perform activities beyond the mere receipt of income which are considerable, continuous, and regular, constitute a trade or business within the U.S. Therefore, the Government of [redacted] is considered engaged in commercial activities within the United States with respect to the real estate investments referred to herein for the purposes of section 892 of the Code.

[redacted]

Accordingly, any income derived from such activities as well as any income which is considered effectively connected with the conduct of such activities under the principles of section 1.864-4 of the regulations is not exempt from Federal tax pursuant to section 892.

It is our understanding that [redacted], [redacted] and [redacted] may make investments and perform services for customers other than the Government of [redacted]. Accordingly, no opinion is expressed as to whether any particular investment or item of income is an investment of, or the income of, the Government of [redacted].

In accordance with section 6.14 of Rev. Proc. 72-3, 1972-1 C.B. 698, a copy of this letter is to be attached to any return to which it is relevant with respect to a completed transaction.

Sincerely yours,

Chief, Corporation Tax
-- Branch

OPTIONAL FORM NO. 10
MAY 1962 EDITION
GSA FPMR (41 CFR) 101-11.6
UNITED STATES GOVERNMENT

Department of the Treasury
Washington, D.C. 20220

Memorandum

TO : John W. Holt
Director, Corporation Tax Division

DATE: MAR 7 1977

FROM : David S. Foster DSF
International Tax Counsel

RECEIVED
MAR 8 1977
DIRECTOR
CORPORATION TAX DIVISION

SUBJECT: [redacted] -- Section 892

This is in reply to your note of February 14, requesting our views with respect to a proposed ruling to [redacted]. We have no objections to the issuance of this ruling if the following changes are made. First, on page 5, we recommend that the paragraph beginning "Where an integral part...", be deleted from the ruling letter. We question whether it is necessary to include this rationale in the letter and, in any event, it appears to be somewhat inconsistent with the conclusion of the letter. Second, we recommend that the last paragraph beginning on page 5 be revised to read as follows:

> "The U.S. activities of the Government of [redacted], imputed to it through the activities of its U.S. agents and independent contractors who, with respect to the aforementioned investments, perform activities beyond the mere receipt of income which are considerable, continuous, and regular, constitute a trade or business within the United States. Therefore, the Government of [redacted] is considered engaged in commercial activities within the United States with respect to the real estate investments referred to herein for the purposes of section 892 of the Code."

7612 55371
TCC

[redacted]

December 17, 1976

Telephone [redacted]

Commissioner of Internal Revenue
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Attn.: T:I:C:31 - Mr. Kim Palmerino

AMPLIFICATION OF A REQUEST FOR EXEMPTION FROM TAXATION UNDER SECTION 892 OF THE INTERNAL REVENUE CODE OF 1954

Dear Sir:

On Thursday, December 2, 1976, the undersigned and [redacted], of the law firm of [redacted], in a representative capacity for the taxpayer herein, [redacted] ("[redacted]") met with you to discuss certain issues which had arisen from a [redacted] request for your ruling recognizing an exemption under Section 892 of the Internal Revenue Code. At this conference certain legal and factual questions arose upon which we were asked to reply by supplying factual information or legal argumentation. Our response to these various factual questions and legal points are contained below.

RECEIVED
DEC 28 1976
CORPORATION TAX BRANCH
CORPORATION TAX DIVISION

I

INCOME RECEIVED BY THE GOVERNMENT OF [redacted] FROM PRESENT OR PROPOSED U.S. SOURCES IS EXEMPT FROM TAX UNDER SECTION 892 OF THE INTERNAL REVENUE CODE.

On its face Section 892 of the Internal Revenue Code is broad and unlimited in its scope. The section exempts income of foreign governments which is received:

a. "from investments in the United States in stocks (and other securities)."

b. "from interest on deposits in banks in the United States."

c. "from any other source within the United States."

Section 861 describes sources of income within the United States generally. Section 861(a) (4) provides that rentals from property in the United States is income from sources within the U.S. In the face of the tax exemption in Section 892 to income "from any other source within the United States," it is difficult to assert that Congress intended to limit the scope of Section 892. Certainly with respect to the type of income that the Government of [redacted] receives, without congressional action, Section 892 is apparently unlimited.

Congress is certainly aware of the growing investment activity of foreign governments in the United States. Recently in considering the 1976 Tax Reform package, Congress ignored Senator Hartke's informal proposals to amend or repeal Section 892.

The Service has suggested the following limitations in their interpretation of the section:

1. The section was intended only to apply to foreign government acting in its sovereign capacity;

2. When a foreign government engages in "commercial activity," it is not acting in its sovereign capacity and therefore Section 892 does not apply;

3. "Commercial activity" is activity which is substantially the same as an activity which would constitute a "trade or business" under other sections of the Code.

[redacted] submits that such an interpretation of this section would be more restrictive than Congress intended and would be unwarranted by basic rules of statutory interpretation. If a limitation is to be found, [redacted] submits that it must be drawn in such a way as to honor the express congressional intent of encouraging the investment of capital of foreign governments in the United States. The Service's suggestion would tax all but a few of such investments.

The one word in the section which arguably could be interpreted as a word of limitation is "investment." The issue is presented of whether that word of limitation can, through a process of interpretation, be translated into "trade or business."

"Trade or business" is an extremely broad term which describes almost any economic endeavor (see, e.g., Snow v. Commissioner, 416 U.S. 500 (1974)). That term is used in sixty other sections of the Code; thus, Congress has not been timid about its use when it wishes to describe a wide range of economic activities.

In 1960 and 1966, Congress addressed the subject matter of tax exemptions of foreign governments when it enacted and later amended Section 895. Section 895 exempts certain income of foreign central banks, unless the income is used in connection with the conduct of "commercial activities." Congress chose not to employ "trade or business" as the limiting language of Section 895. But with Section 892 Congress adopted no express words of limitation. Therefore this section provides a broader exemption than that provided by Section 895. The Service made that observation in Revenue Ruling 76-329, I.R.B. 1976-26,7.

Whatever the original congressional intention may have been in enacting Section 892, Congress has supplied us with some indications of its views of that section by its inaction in the face of wide ranging investments by foreign governments, by its failure to limit Section 892 as it has Section 895, and by its refusal to amend the statute as noted above.

A limitation of Section 892 which is more reasonable in light of legislative history is to exempt income derived from passive sources and tax that from active sources. Congress has employed those standards in the special rules relating to real estate investment trusts (REITs) in Section 856 et seq., and the rules and regulations under Section 856 are sensible and practical guides for Section 892. So limited, Section 892 will still satisfy the congressional intention of encouraging investment of capital by foreign governments, conditioned upon all managerial and other active business pursuits being undertaken by independent contractors.

Encouragement of investment by foreign governments serves to help the U.S. balance of payments problems and to create a keen interest on the part of those governments in the strength of the United States economy. Additionally, the large amounts of capital needed to stimulate the U.S. economy and its ability to create new employment will be fostered without permitting foreign governments to operate active businesses in competition with U.S. companies.

II

INCOME FROM REAL PROPERTY, THE MANAGEMENT OF WHICH IS THE RESPONSIBILITY OF AN INDEPENDENT CONTRACTOR OR A LESSEE UNDER A NET LEASE, IS INCOME WITHIN THE EXEMPTION OF SECTION 892.

Currently, the government of [redacted] has invested in two categories of real estate investment. One type is a triple net lease where the government of [redacted] purchases developed real estate which is already subject to a long-term triple net lease. By the term "triple net lease" we mean a lease where the lessee pays the real estate taxes, assumes responsibility for the maintenance of the property and assumes responsibility for insuring the property.

The second type of real estate investment is characterized by a multiple unit building where activities are required on the part of the owner beyond the mere collection of income and payment of expenses incidental thereto. Even in this second type of investment, however, the government of [redacted] will earn no income from management activities. All real estate management activities which are or will be necessary with regard to these more active real estate investments are and will be carried on by independent real estate management contractors who will be hired by [redacted] for the government of [redacted] These management contractors will manage and maintain the premises and deal with and find tenants in their management capacity.

Rental income which is theoretically attributable to active management of the real estate investment will be paid to the independent property management contractors as compensation for their services. The income flowing to the government of [redacted] will, thus, be netted out as will the income flowing from a triple net lease transaction so that no income relating to activities rendered with regard to the real estate will flow to the [redacted] government. All income earned from business type activities connected with U.S. real estate will be subject to tax in the United States in the hands of such real estate managers.

As discussed above, Congress has developed, in the REIT provisions of the Code, the concept of a passive investor deriving income from an active business source. These provisions articulate the distinction between the passive trade or business of the REIT itself, and the active trade or business of the real property owned by the REIT. So long as the active management of rental real property is vested in the hands of an independent contractor or a lessee under a net lease, the rental income actually received by the REIT will satisfy the passivity requirements under Section 856.

Courts, too, have recognized the distinction between the passive owner of real estate and one who actively manages and developes the real estate as part of his own active business. See, for example, Estate of Mundy, 36 T.C. 703 (1961), acq. 1962-2 Cum. Bull. 5, Voss v. United States, 329 F.2d 164 (7th Cir. 1964), and Smith v. Dunn, 224 F.2d 353 (5th Cir., 1955). In each of these cases, the court recognized that the passivity of the taxpayer was not destroyed by the activities of his independent agent with regard to the real estate in question.

[redacted] therefore submits that an interpretation of Section 892 which recognizes the distinction between the activity of the local manager or operator of real property and the passivity of the owner will best satisfy the interests of the United States and the government of [redacted]. Such an interpretation will not give a competitive advantage to the foreign government.

III

OTHERWISE EXEMPT U.S. SOURCE INCOME DOES NOT FAIL TO QUALIFY UNDER SECTION 892 BECAUSE IT IS EARNED BY A DOMESTIC CORPORATION WHOLLY OWNED BY THE GOVERNMENT OF [redacted].

It is contemplated that investments made by the government of [redacted] may, in the future, be made through a wholly-owned domestic corporation. At the conference with your representatives there was an indication that the Internal Revenue Service would deem any investment made through a domestic corporation by a foreign government as failing to come within the scope of Section 892. We disagree with this position. It is our opinion that under the current state of the law a domestic corporation is an appropriate vehicle for investment in U.S. income producing property by a foreign government within the scope of Section 892 so long as that entity limits its activities to those permitted the government itself.

Prior to 1975 the Service had administratively limited the application of Section 892 to organizations wholly owned by a foreign government so long as such organizations were not "corporations" as that term is understood in the United States. Rev. Rul. 66-73, 1966-1 Cum. Bull. 174. During the pendency of the ruling being sought herein, however, the Service in 1975 revoked Rev. Rul. 66-73 in Rev. Rul. 75-298, 1975-2 Cum. Bull. 290. 75-298 held that income earned by a foreign bank that qualifies as a central bank of issue under Section 895 of the code, or <u>by any other organization created by a foreign government</u> which does not engage in "commercial activities" (on more than a <u>de minimis</u> basis in the United States) qualifies for exemption under Section 892 so long as such organization:

1. is wholly-owned and controlled by the foreign government

2. receives income only from investments and from the foreign government

3. retains its income or distributes it to the foreign government, with no part inuring to the benefit of a private person, and

4. earns its income from investments which produce only passive income.

In light of the language of this ruling and its revocation of Rev. Rul. 66-73, we submit that a U.S. corporation wholly-owned by a foreign government, fits within the scope of the "any other organization" language contained in 75-298.

The fact that a corporation is created under the laws of one of the United States does not defeat this conclusion. In this situation the foreign government does not lose its identity or sovereignty but only submits to the power of a state to the extent of the assets held by the corporation. These assets would be subject to the power of the state where the real estate is located in all events.

The formation of a domestic corporation by the foreign government should not destroy the exemption of Section 892 so long as the Government is the sole shareholder and enjoys all the benefits of corporate distinctions. The use of domestic corporations is sometimes required by State law. (See e.g. Pennsylvania). More importantly, the use of a corporation greatly facilitates the owner's role with respect to the property. Without a corporation, special powers of attorney must be maintained, and it is difficult to frame broad yet specific powers that a local property manager may need for transactions which must be anticipated. If a corporation is formed, the officers and directors can include U.S. residents who can sign documents on behalf of the corporation.

We, therefore, submit that the utilization of a domestic corporation wholly owned by a foreign government to hold title to an investment in U.S. real estate comes within the exemption afforded by Section 892 so long as the income derived would be exempt if the investment was held directly by the foreign government.

IV

SUMMARY OF INVESTMENTS OWNED BY STATE OF [redacted], ACTING BY AND THROUGH THE MINISTER OF FINANCE AS OF DECEMBER 1, 1976 UNDER [redacted]'S ADVISORY AGREEMENTS

In our conference of December 2, 1976 you requested that we supply certain information concerning the current [redacted] government investment portfolio. This information is listed below:

Property	Purchase Price	Title Held As
I. Triple Net Lease		
Building #1	$ 1,264,291.50	
Building #2	$ 1,150,624.99	
Building #3	$ 3,642,208.00	
Building #4	$ 2,676,293.37	
Building #5	$ 3,932,526.51	
Building #6	$18,028,509.66	
Building #7	$ 1,095,098.19	
Building #8	$ 7,353,748.86	
Building #9	$ 1,244,056.70	
Building #10	$ 1,885,920.50	

~~Building~~ has two tenants - office space and garage operator. Investor pays only insurance and taxes.

[redacted]

1/4/77

Property	Purchase Price	Title Held As
II. Multi-Tenant Commercial		
NONE		
III. Multi-Tenant Residential		
Apartment #1	$14,792,031.93	[redacted] ?
IV. Limited Partnership		
Limited Partnership #1 1/3 limited partnership interest	$ 6,071,366.16	[redacted]

(Partnership owns a large vacant land parcel which it sells or leases to others for development, light industrial buildings under long-term leases, commercial and retail space, and a 50% interest in a corporation. The Government of [redacted] also made a $9,000,000 mortgage loan to the partnership. Under certain circumstances, the Government of [redacted] can convert this loan into additional partnership interest to bring it up to a total 50% limited partnership interest)

light industrial commercial park
some triple net lease
50% interest in corp which develops the shop center & leases it leased

pship-

You had requested a representation that the investments described above were all of the Government of [redacted]'s investments in the United States. We advised the Service's representatives that it would be unlikely that such a representation could be made. [redacted] is not the exclusive investment advisor to the Government, and has no ability to inquire into [redacted]'s other investments. We submit that, if the limitation on Section 892 suggested herein is adopted, other investments of the Government of [redacted] would not affect a positive ruling with respect to those investments or any others which fall within a passive characterization.

Before any decision is made which is inconsistent with the foregoing, or if additional information is requested in connection with this application for ruling, please call the undersigned at [redacted].

Respectfully submitted,

[redacted]

[redacted]
Associate Tax Counsel

Memo to the File

In G.C.M. 35119 it was held that the active conduct of a trade or business requirement of section 355 of the Code had not been met where the taxpayer engaged primarily in the leasing of real estate properties managed and operated through independent contractors in compliance with the REIT provisions under section 856.

It thus appears that rental income qualifying under section 355 as being derived from the active conduct of a trade or business could not qualify as passive income under section 856. In light of the parallel drawn between sections 856 and 892, it is our view that standing alone, income derived from the active conduct of a trade or business could never qualify under section 892.

Additionally, foreign personal holding company income (which has the same characteristics as passive income under sections 856 and 892) can not include rents which are derived from the leasing of real property with respect to which the lessor performs active and substantial management and operational functions while the property is leased. See section 1.954-2(d)(1)(ii)(a)(2) of the regulations.

Although it may be an issue in the instant case, the term "independent contractor" has not been defined for purposes of section 892. We recognize that the definition of that term has a different meaning for example, under section 856 from the meaning it is given under section 894. The undersigned is of the opinion that a strict definition (i.e. an unrelated 3rd party acting in the ordinary course of his business or acting in his independent capacity) is preferable.

A review of the Policy Memorandum from CC:LR to the Policy Committee discloses that under issue 9a, the definition of net lease is referenced to section 57(c) of the Code. That definition would materially differ from the definition used in the proposed ruling letter.

In issue 11a of the Policy Memorandum, in attempting to define "commercial activities" no-distinction is made between income which is "actively" derived from a commercial activity and that which is "passively" derived.

T:C:C:3:1
KAP Kim A. Palmerino
2/17/76

Conference Report
(See Instructions on Reverse)

1. Name of Taxpayer	2. Time Consumed
[redacted]	3 hours

3. Subject of Conference	4. Date, Time and Place Held
Exemption of Income Tax for the [redacted] Government	12/2/76 10:00 A.M. Room 5020

5. Name(s) of Taxpayer or Representative(s) attending Conference	6. IRS Conferees
[redacted]	Kim Palmerino TCC 3:1 Paul Miller TCC 3

7. Brief Resume of Conference, Including Conclusions Reached (*List Code sections involved*)

The conference began with a discussion and clarification of the structure of the transaction. Once having established the relationships and duties of the various parties, the conferees focused upon the facts underlying the actual investments made on behalf of the [redacted] Government. Messrs. [redacted] and [redacted] related that the investments fell into three major categories: (1) net leases consisting of five to ten in number; (2) three to four multiple commercial properties such as office buildings, not subject to net leases but managed by independent contractors who have express authority to contract on behalf of [redacted]; and, (3) a minority interest in a U.S. partnership which owns commercial property not subject to net leases, the management of which is placed with independent contractors. The Service conferees requested a written submission from Mr. [redacted] describing all the above-mentioned investments in detail.

Mr. Palmerino next expressed the Service's tentative position with respect to issues involved:

(1) That the standard applicable to determine whether a foreign government per se is entitled to an exemption pursuant to section 892 of the Code is whether the foreign government is engaged in commercial activities in the U.S.

(2) That the term "commercial activities" includes being engaged in a trade or business;

(3) That the activities of the [redacted] Government, imputed to it through the activities of its U.S. agents, constitute a trade or business within the U.S.;

8. Signature of Person Preparing Report	9. Date	10. Organizational Symbols
Kim A. Palmerino	12/2/76	T:C:C:3:1
11. Signature of Person Approving Report	**12. Date**	**13. Organizational Symbols**
Paul T. Miller	12/3/76	TCC:3

Form M-1936 (Rev. 5-73) Dispose of all prior issues Page of pages

[redacted]

(4) That the income from the net leases would not qualify under section 892 because it is effectively connected with the conduct of a trade or business;

(5) That income from net leases, not effectively connected with the conduct of a trade or business, may not qualify for an exemption;

(6) That Rev. Rul. 75-298 may not apply to a U.S. or third country corporation;

(7) That the Service may decline to rule with respect to income from real estate title to which is held by a nominee for an undisclosed principal.

A substantive discussion of these issues followed. In discussing the issue of whether the [redacted] Government is engaged in a trade or business, Mr. Miller inquired whether [redacted] could obtain representations from the Government of [redacted] as to its total U.S. investment. Mr. Miller explained that such representations would be required in order to decide the trade or business issue which is primarily a question of fact. The taxpayer was informed that absent the representations the Service would be left with two possible options; caveating the ruling or declining to rule because of insufficient facts.

A summary of the positions was discussed and the taxpayer was informed of the Service's withdrawal procedure with respect to an adverse ruling.

The conference adjourned at 1:00 P.M. with the taxpayer agreeing to submit the requested information and a legal brief. For business reasons, the taxpayer requested the Service to make its determination not later than January 15, 1977.

Memo of Telephone Conversation of 10/26/76

[redacted] ([redacted]) called and stated that [redacted] (on P of A) had called Parsky at MT. Parsky referred him to Walker. After speaking to Walker about the [redacted] ruling request – apparently [redacted] was told that the conference scheduled for 10/28 would be postponed. Mr. Walker wanted to be informed of the IRS's position with respect to the various issues. [redacted] also inferred that Mr. Walker may make policy decisions with respect to the various issues.

I told [redacted] that as far as I was concerned the conference was postponed and that I would get back to him after conferring with my people as well as with MT.

I spoke to Paul Miller. He suggested we appraise Mr. Goldwag of the turn of events. Mr Goldwag suggested that we call Mr. Foster to get a clarification & some direction. It was decided that MT's intervention into this case at this time was due to 1 of 2 possibilities –

1. A lack of communication (to Mr. Walker) from the 9/16/76 conference – which may have no effect upon our current views
2. MT's decision to change our tentative position on policy grounds.

10/29/76 Called Mr. Foster x5046 – he was at a meeting and will get back to me.

KA Palmerino
T:C:C:3:1 10/29/76

10/27/76 Mr Foster returned my call. I explained the course of events leading to my postponement of the [redacted] conference. Mr Foster stated that apparently T/P called MT to see whether IRS was locked in to the position conveyed - and whether it was worth their while to come to D.C. for the conference. T/P apparently misstated our tentative position with respect to net leases of real estate (saying that our position was that all net leases were tainted) which caused Mr. Walker some concern. I reiterated to Mr. Foster what our position was; he was in agreement. Mr. Foster stated that he had prepared a memo from Walker to Pusky outlining our position (adopted at the 9/16/76 conference). Once they have approved it (the 1st of next week) I should receive a call from Mr Foster instructing me to proceed with the conference - at which time I shall reschedule the conference.

10/27/76 I informed Messrs Hammes & Miller of my actions.

86-722 O - 82 - 41

Telephone call to [redacted] obtaining Service's views and setting up a conference 9/23/76 2:00 AM.

1) Service views std. for gov't per se same as for 75-298 organizations — commercial activities

2) Service considers term "commercial activities" as including a trade or business

3) We consider activities of [redacted] Gov't through its agents & through U.S. independent contractors as constituting a trade or business

4) Income from net leases also bad because its effectively connected with t&b

5) We have reservations as to whether net leases standing alone could qualify

6) We have reservation as to whether Rev. Rul. 75-298 can apply to a U.S. or 3rd country corp.

7) Even should you overcome our concerns in 1-6 above, we are skeptical about issuing any ruling which will effect the income from real estate — where the real party in interest is not disclosed on all official documents

Cont'd

Conference Report
(See Instructions on Reverse)

1. Name of Taxpayer
[redacted]

2. Time Consumed
2 hours 15 minutes

3. Subject of Conference
Standard to be applied under § 892 with respect to real estate investments by a foreign government per se and by its wholly-owned entities

4. Date, Time and Place Held
9/13/76
10:00 A.M
Room 5507

5. Name(s) of Taxpayer or Representative(s) attending Conference

6. IRS Conferees
Mr. Goldwag T:C
Mr. Miller T:C:C
Mr. Blumkin CC:LR
Mr. Hannes T:C:C:3:1
Mr. Bonanno CC:LR
Mr. Palmerino T:C:C:3:1

7. Brief Resume of Conference, Including Conclusions Reached (List Code sections involved)

The conference was convened by Mr. Palmerino who stated the issues to be discussed were (1) whether or not a U.S. corporation could receive an exemption under the standards of Rev. Rul. 75-298 and (2) whether for purposes of real estate investment, the definition of "commercial activities" under section 892, as extended by Rev. Rul. 75-298, should be limited to the concept of engaged in a trade or business or should be broader.

With respect to issue (1), Mr. Goldwag stated that we ought to present the issue to the taxpayer; that if the issue were an open one, the proposition that only local organizations (i.e., organizations created under the laws of the foreign country whose government is applying for the § 892 exemption) may be exempt under § 892 is supportable. The support is derived from the premise that the sovereignty of a foreign government is in question where its wholly-owned organization is a creature of U.S. or state law.

Mr. Blumkin emphasized that CC:LR could support a result either way but strongly felt that the issue has to be resolved as a matter of policy. It was decided to present the issue to the taxpayer, leaving the question open at this time.

With respect to issue (2) T:C strongly voiced the view that the term "commercial activities" should be construed broader than CC:LR's definition of engaged in a trade or business. Citing the historical purpose of utilizing such a vague term, Messrs Goldwag, Miller and Hannes were of the opinion that under such a standard, different criteria could be developed area by area on an ad hoc basis. For example, for ruling purposes, the Service could take the view that all "cultural activities" are non-commercial but all "real estate investment activities" are commercial.

Mr. Blumkin stated that his assignment was to develop a legal

8. Signature of Person Preparing Report	9. Date	10. Organizational Symbols
Kirk A. Palmerino	9/13/76	T:C:C:3:1
11. Signature of Person Approving Report	**12. Date**	**13. Organizational Symbols**
[signature]	9/10/76	TC

Form M-1936 (Rev. 5-73) Dispose of all prior issues Page of pages standard and his opinion was that the concept of engaging in a trade or business more precisely achieved that purpose. He voiced the opinion, however, that the solution to this issue, as with issue (1), more properly should be resolved as a matter of policy.

The conferees thought it best to ask Mr. Withers whether he deemed it appropriate at this time to touch base with Treasury before relating our views to the taxpayer. Mr. Goldwag agreed to call Mr. Withers, relate the results of the conference and pose the question regarding Treasury's participation prior to relating our views to the taxpayer and scheduling a conference of right.

page 2 of 2 pages

Mr. Clark 7/9/76
Attn S. Haynes.

Your premise is that ~~[illegible]~~ commercial activities ~~[illegible]~~ and "trade or business" ~~[illegible]~~ appear to be synonymous terms. √
∴ if the activity does not meet the ~~[illegible]~~ trade or business test it does not meet the comm'l activities test.

I do not accept this premise. Many activities can be commercial but not trade or business.

~~[illegible]~~ The key here is that the ~~activity or~~ activity must be in concert with the concept of a foreign gov't acting in its sovereign capacity. — IS IT?
Leo (see next page)

(1) Under what theory is this case proceeding? 75-198

OR

integral part of the Govt.

(2) Nominee role of [redacted] & [redacted] or for nevers with [redacted] as the shareholder

is this position acceptable by TCC?

(SPECIFICALLY RULING #5)

(3) Pg 3- How does cash flow from [redacted] to [redacted]?

(4) Pg 3- What is a triple net lease. "Commonly referred to"! explain at pg 3

Explain it.

1/30/76

Mr. Hannes

I have read the memo for the file and I still have trouble agreeing that the [redacted] Government is not engaged in commercial activities as to its real estate operations.

I do agree that it is not engaged in an "active trade or business" but Rev. Rul. 75-298 does not use that term. It clearly says the foreign Government cannot engage in "commercial activities" (by U.S. Standards). As written, the reply stands for the proposition that all properly run REITs are not engaged in "commercial activities" as the U.S. uses that term; Also, it stands for: that ~~[illegible]~~ some of the cases mentioned in the GCM's in the file, although not engaged in the active conduct of a trade or business are, as a result, not engaged in "commercial activities". ([redacted] , e.g.)

How far will this go in the future? Will a foreign govt. be able to ~~[illegible]~~ buy aircraft and net lease them to U.S. Airlines? Fleets of trucks? Buses? Ships? Banks run by independent operators? Hockey teams?

I agree that the income will be passive under prior case law, regs, GCM's, etc., but until the term "commercial activity" is met head on, or deleted from Rev Rul 75-298, I cannot agree with this answer.

Even if we will be forced to go this way for policy reasons I believe the [redacted] thought in the preceding sentence must be resolved.

If you wish, we can wait for P. Miller to get his input on my question.

Moreover, since we use the term nominee in our reply possibly it should be looked at by Mr. Manfreda who is in the midst of clarifying the nominee area.

Fix typos - see paper clips.

You may sign the M-3514

Update the Form M-4114

John Clark

Memo to the File

Had the determination been made that the Government of [redacted] was not engaged in a trade or business within the U.S. by virtue of its real estate activities, the Service may not have been able to rule for the following reasons:

(1) The taxpayer's representative was unable to make a representation with respect to whether the [redacted] Government had other U.S. investments through another investment advisor. Such information would be required to determine the existence or nonexistence of a U.S. trade or business;

(2) A nominee problem exists in the case of four properties where the real party in interest has not been disclosed on the title instrument. (See taxpayer's submission dated December 17, 1976).

Keni A. Palmerino
T:C:C:3:1
1/5/77

Memo to the File

On December 12, 1975, a meeting was held (attended by MT, AC (T) CC and T:C) at which it was decided that for purposes of section 892 of the Code the term foreign government meant a foreign government acting in its sovereign capacity; that a foreign government was not acting in that capacity when it was engaged in commercial activities (by U.S. standards) within the U.S.; and, that income derived from such activity would not be considered to be the income of foreign governments within the meaning of section 892.

The ruling letter in the instant case provides no underlying rationale in reaching its determinations. In order to make such determinations, and in accord with the decision at the December 12th meeting, it is necessary to define "commercial activity" in terms of the specific facts on a case by case basis. This memorandum provides the reasons for the view that the particular types of real estate investments involved do not constitute "commercial activity" as that term is used in relation to section 892.

Keeping in mind that the legislative purposes underlying the enactment of section 892 has been viewed by the Service to be to exempt the income of foreign governments derived from passive investments in the U.S. (e.g., See Rev. Rul. 75-298, 1975-30 I.R.B. 16), it would be in accord with that purposes to exempt income which is of the same passive character.

It is our position that income derived from "net" leases (defined on page 3 of the ruling letter) is income with the same passive character as the income received from the specific investments enumerated in section 892 and Rev. Rul. 75-298 and, consequently should be exempt under section 892.

The Service's position under section 892 of the Code and the legislative history underlying section 856, dealing with real estate investment trusts (REIT), are parallel. In enacting section 856, Congress wanted to draw a sharp line between passive investments and the active operation of a business. In order to do so, the definition of rents under section 856 excludes amounts received where the REIT directly furnishes or renders services to the tenants or manages or operates the property. However, the bill permitted such services, or management or operation of the property to be provided through an independent contractor. See H.R. Rept. 2020, 86th Cong., 2d Sess., (1960).

Ar ng

Lerner of Treasury.

Treas. gave [redacted]
no encouragement
in meeting on 3/11
(prior to meeting here).
They want NO part of
our decision; i.e.,
work it out in the
service! They would
like to hear our answer
after we mail.

Steven Horn

3/13/75

T:C:C:3:1

[redacted]

Rec'd 1-24-75

January 21, 1975

Air Mail Special Delivery

Commissioner of Internal Revenue
Internal Revenue Service
Internal Revenue Building, Room 520
1111 Constitution Avenue Northwest
Washington, D.C. 20224

ATTEN: Mr. Kim Palmerino

RE: Ruling Request Concerning the Exemption of a Foreign Government from Taxation of U.S. Source Income Dated [redacted]

Dear Sir:

In a January 15, 1975 telephone conversation, your representative, Mr. Palmerino, requested elaboration upon the following subjects as a supplement to our earlier ruling request.

1. Debt Structure of [redacted] ([redacted]):

[redacted] is a corporation organized and existing under the laws of the country of [redacted]. [redacted] is funded entirely by paid in capital for which shares were issued to [redacted] and other shareholders as described in our ruling request. [redacted] has not currently financed any of its operations through borrowings and does not contemplate the incurring of any debt in the future.

2. The Handling of Cash Flow by [redacted] from the Various [redacted] Investments:

As described in our ruling request, [redacted] will be trustee for the investment account of the [redacted] government through its [redacted]. Investments made in the United States for the account of the [redacted] government will have title taken in the name of "[redacted]

[redacted] as Trustee for the [redacted]". Management of the investment portfolio has been contracted for by [redacted] with [redacted], who in turn has subcontracted with [redacted] for large part of such management services. To the extent [redacted] invests in U.S. real estate as trustee for the [redacted] government, [redacted], as agent for [redacted], will collect rent generated from each such investment. This income will be put into an ordinary checking account in the name of [redacted] as trustee for the [redacted] with [redacted] as acting agent. Between real estate investments these funds will be invested in short term money market investments (generally time certificates of deposit) which generate interest income.

While the [redacted] reserves the right to have investment income paid over to it directly in [redacted], such repayment is not currently contemplated and the various funds generated by investments will remain in the U.S. and be reinvested as described above.

3. Types of Investments Contemplated:

Under the portfolio objectives of the [redacted] government through its [redacted], moneys put into trust with [redacted] are to be used for purchasing equity positions in quality real estate investments in [redacted]. These investments include office buildings, shopping centers, industrial buildings, and, where investment prospects are sufficiently high, raw land. With such a portfolio, they wish to preserve their capital investments, hedge against inflation and, where possible, achieve an annual return on their investments. All real estate purchases will be entered into on a long term basis and will be held for multi-year periods unless the investment becomes unattractive.

As noted above, to the extent funds are not immediately utilized for real property investment, they will be used to purchase money market interest producing instruments such as time certificates of deposit.

Investments in real property will be sought out by [redacted] as an investment origination service. Management of investments will be supervised by [redacted] under its subcontract with [redacted]. Investments will range from Management intensive (renting, rental collection, repairs, etc., through a subcontractor of [redacted]) to passive Management (net leases, raw land, etc.).

Very truly yours,

[redacted]

Assistant Tax Counsel

[redacted]

[redacted]

need significant matter report
PLR

RECEIVED
[redacted]
TECHNICAL SERVICES BRANCH

[redacted]

Commissioner of Internal Revenue
Internal Revenue Service
Washington, D.C. 20224

RECEIVED
[redacted]
pld
CORPORATION TAX BRANCH
INCOME TAX DIVISION

ATTN: T:I:C:31

REQUEST FOR INCOME TAX ~~RULING CONCERNING AN EXEMPTION OF A FOREIGN GOVERNMENT FROM TAXATION OF U.S. SOURCE INCOME~~

RECEIVED
NOV 22 1974
Corporation Tax Branch
Income Tax Division

Dear Sir:

Your ruling is respectfully requested as to the federal income tax consequences to be accorded certain payments to a foreign government, pursuant to Section 892 of the Internal Revenue Code of 1954*, by a subsidiary of [redacted] managing a portfolio of investments for such foreign government in various Western Hemisphere countries including the United States.

PARTIES

[redacted] ("[redacted]"), Taxpayer Identification No. [redacted], is a corporation organized under the laws of [redacted]. [redacted] maintains its principal office at [redacted], and files consolidated Federal income tax returns with the Internal Revenue Service Center, [redacted]. ([redacted] District Office has audit jurisdiction.) [redacted] is the parent

*Unless otherwise indicated, all subsequent citations contained herein will refer to the Internal Revenue Code of 1954 and the regulations issued thereunder.

company of a worldwide commercial banking and financial business operated through wholly owned and partially owned subsidiaries including [redacted].

[redacted] ("[redacted]") is an international real estate consulting and management service organization organized under the laws of the State of [redacted] and has its principal office at [redacted]. Currently, the activities of [redacted] are awaiting [redacted] approval. Upon receipt of such approval, [redacted] will engage in worldwide operations and will join with [redacted] in filing a consolidated tax return at the Internal Revenue Service Center, [redacted]. A taxpayer identification number will be applied for after [redacted]'s activities are approved by the [redacted]. ([redacted] Certificate of Incorporation is attached hereto as Exhibit A.)

Have been granted

[redacted] ("[redacted]") will be an investment advisory organization that will specialize in real estate investment and will be organized under the laws of the Country of [redacted]. [redacted] will have 15,000 shares of common stock authorized and outstanding (the only class of stock). [redacted] will own 48% of these shares. The remaining stock will be owned by unrelated [redacted] investors. ([redacted] Articles of Association are attached hereto as Exhibit B.)

<u>PROPOSED INVESTMENT TRANSACTION</u>

The [redacted] Government, through its [redacted], currently plans to invest substantial funds in real estate located in [redacted]. Such investment activities will be carried out through arrangements with a series of entities. Firstly, the [redacted] has entered into an agreement with the [redacted] (hereinafter referred to as [redacted]), a financial institution owned by private persons, to provide for the investment and management of government funds. (Exhibit C is attached hereto.) Such agreement purports to establish a trust under [redacted] law. Under the terms of this [redacted] trust, [redacted] is charged with the duty of managing, investing and reinvesting the government funds and of collecting income therefrom. The government is both grantor and beneficiary of the purported "trust" and has reserved the power to revoke and amend as well as the power to demand payment over to it of any and all funds in the so-called trust.

Not possessing the needed expertise to engage in [redacted] investment activities on its own behalf, [redacted], in conjunction with [redacted], formed [redacted] (three individual investors also hold 2% of the stock in [redacted]). The formation of [redacted] was not for the purposes of avoiding Federal income taxes, but was the result of the sound business interests of [redacted] and [redacted]. Furthermore, the [redacted] Government insisted that [redacted] have a proprietary interest in the management vehicle to insure close control over the investments made with government money. [redacted], on the other hand, will engage in consulting and management activities with various investors, including but not limited to [redacted], and, therefore, insisted on remaining wholly owned for management control reasons as well as avoidance of conflicts of interest.

After formation of [redacted], [redacted] will enter into a contract with [redacted] that requires the latter to originate and manage various real property and other investments in [redacted]. [redacted] will employ a small staff of investment origination personnel who will actively seek out real property investments in [redacted] and will maintain a branch office in [redacted], in addition to its main office in [redacted] as well as offices in other countries. [redacted] will receive fee income consisting of a fixed percentage of each investment, an annual fixed percentage of the entire portfolio, ~~and a fixed percentage of dispositions out of portfolio~~. what does this mean [redacted] will subcontract for real estate technical services on a cost reimbursement basis with [redacted]. [redacted] will be composed of a small staff that is experienced in real estate appraisal and analysis, underwriting and administration. [redacted] will evaluate and advise [redacted] personnel and will provide all accounting and reporting for [redacted]. [redacted]'s source of gross income for these activities will be dividends received from its 48% equity interest in [redacted] and cost reimbursements based upon actual expenses. Cash flow will be remitted by [redacted] directly to [redacted] for the account of the [redacted] unless [redacted] is instructed to retain and reinvest such funds. Funds awaiting reinvestment will be invested in short term, interest producing assets.

The purpose of this request for ruling is to obtain a confirmation that income upon funds invested by the [redacted] Government through its [redacted] will be exempt from taxation under Section 892 so that [redacted], as withholding agent as defined in Section 1465, will not be required to withhold taxes imposed by Section 1441(a) or 1442(a). Section 892 provides in pertinent part that "The income of foreign governments.....received from investments in the United States in stocks, bonds or other domestic securities, owned by such foreign governments....., or from interest on deposits in banks in the United States of moneys belonging to such foreign governments....., or from any other source within the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle." This Section, thus, provides a general exemption from income tax for U.S. source income of foreign governments.

The Internal Revenue Service has ruled in the past that, in order for United States source income to be exempt, the property producing income in question must be owned by the government claiming the exemption (Rev. Rul. 69-361, 1969-1 C.B. 193). In the described situation this requirement is met in that the Government of [redacted], through its [redacted], deposited wholly owned funds with [redacted] to handle its [redacted] investments. The fact that title to ultimate investments may be held by [redacted] as trustee should be disregarded for the purpose of satisfying such requirement. Under the terms of the agreement between the [redacted] and [redacted], the so-called "trust" is merely a vehicle for investment convenience and, thus, more closely resembles an investment management contract. The fact that the [redacted] Government is both the grantor and beneficiary and reserves broad powers to amend, revoke and withdraw any and all funds from [redacted] dictates such a finding.

Furthermore, even if such relationship fits within the broad "trust" definition contained in Reg. Section 301.7701-4, the Internal Revenue Code under Subchapter J would view payments to [redacted] as made directly to the [redacted] Government under the grantor trust rules (Sections 671 to 678).

Since investments made by the [redacted] are properly viewed as made by the [redacted] Government directly, there is no intervening corporate entity to cut off the [redacted] Government's exemption under tests expressed in Rev. Rul. 66-73, 1966-1 C.B. 174.

RULING REQUESTED

On the basis of the foregoing facts and the applicable law, your ruling is respectfully requested to the effect that investment income collected by [redacted], as an investment portfolio manager, and payable to [redacted] for the account of the [redacted], a department of the Government of [redacted], will, to the extent it is from United States sources, be exempt from United States taxes under Section 892 and, therefore, no withholding will be required under Sections 1441 and 1442.

To the best knowledge and belief of the undersigned, the issues presented in this request are not pending before any other office of the Internal Revenue Service.

The undersigned declares under penalty of perjury that the facts stated here and in the attachments are true and correct to the best of his knowledge and belief.

If additional information is requested in connection with this application, please call the undersigned at [redacted], or [redacted]. If any question should arise regarding the issuance of any portion of this ruling, a conference is requested.

Respectfully submitted,

[redacted]

General Tax Counsel

[redacted]

Attachments

APPENDIX 5.—MATERIAL BEARING ON ADEQUACY OF U.S. GOVERNMENT EFFORTS TO MONITOR OPEC AND OTHER COUNTRY FOREIGN PORTFOLIO INVESTMENTS IN THE UNITED STATES

A. DATA SOURCES FOR OPEC COUNTRY (1) CURRENT ACCOUNT SURPLUS DATA AND (2) INVESTMENT FIGURES: AND GAO REPORT DIGEST ON U.S. GOVERNMENT INADEQUACIES

ACTION BRIEFING INFO

Inter-Office Memorandum

Date: June 12, 1979

For: Assistant General Counsel Russell L. Munk

Thru: Deputy Assistant Secretary Nachmanoff

From: Robert G. Pelikan

Subject: Description of International Organization Documents Used as Information Sources for IDN's Estimates of the OPEC Current Account Surplus

1. IMF Documents

a. IMF Consultation Reports (Confidential)1/. The most frequently used reports are from general or biennial consultations conducted under Article IV of the Articles of Agreement of the Fund. For each consultation there are generally two reports--a Recent Economic Trends and a Staff Report--which provides detailed information on the economy, including its balance of payments positions, trends, and short-term outlook.

b. Balance of Payments Yearbook, International Financial Statistics, Direction of Trade (Unclassified)1/, these three monthly publications provide relatively current summary statistics covering the financial, monetary, economic, trade and balance of payments situation for each reporting country.

2. IBRD Documents:

For a particular country, the most frequently used is the Memorandum on the Current Economic Position and Prospects (Confidential)1/. This report is generally done every two-to-four years for each country borrowing from the World Bank. Occasionally, an IBRD project document is used.

3. OECD Documents:

Global Financial Flows: The External Position of

	Initiator	Reviewer	Reviewer	Reviewer	Reviewer
Surname	IDN-Wolkow	IDN-Banque			
Initials/Date					

OS F 10-01.2 (6-77), which replaces OS 3275 which may be used until stock is depleted.

Major World Zones (Confidential)[1]. This and similar documents containing projections of the overall OPEC Surplus prepared by OECD and member country staffs during their preparations for each quarterly OECD Economic Outlook.

1/ Use restriction of the document established by the institution.

Data Sources: OPEC Assets and Disposition of Surpluses

I. U.S. Government Reporting Systems

A. Treasury International Capital

1. Printouts from Curtis (Wolfe) or

2. Printouts from Keyser

a) BL Forms

b) S Forms

c) C Forms

B. Commerce - 1) U.S.G. capital movements reports

contact -- Greg Thomas: 523-0614

2) Survey of Current Business -

June issue, direct investment

C. Federal Reserve Quarterly reports on branch assets and liabilities by country of customer.

contact -- Rod Mills

supplied by June Duarte: 452-3558

II. Bank of England

A. Quarterly Bulletin

B.

1)

2)

III. International Financial Statistics: International Reserves and foreign exchange reserves--principally for OPEC members outside mideast, also Liab. of Swiss bank Trust departments.

IV. Bank For International Settlements

A. Statistics of Eurocurrencies

B. Unpublished geographic tables

1. all reporting countries

2. G-10 plus Switzerland

3. 7 reporting European countries

V. Vene uela - airgrams on foreign exchange transactions

VI.

VII. CIA

A.

B.

VIII. Germany - occasional report in Bundesbank monthly on German B/P with OPEC

With the removal of the deleted part of this document,
this document is unclassified

Data Sources: OPEC Assets and Disposition of Surp

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C. Federal Reserve Quarterly reports on branch assets and liabilities by country of customer.

contact -- Rod Mills

supplied by June Duarte: 452-3558

II.

A. Quarterly Bulletin

B. Data exchange via Don Curtis

1) Bank reported assets and liabilities.

2) Bank of stimates of OPEC assets and disposition of surpluses

III. International Financial Statistics: International Reserves and foreign exchange reserves--principally for OPEC members outside mideast, also Liab. of Swiss bank Trust departments.

With the removal of the deleted part of this document, this document is unclassified.

IV. Bank For International Settlements

A. Statistics of Eurocurrencies

B. Unpublished geographic tables

1. all reporting countries

2. G-10 plus Switzerland

3. 7 reporting European countries

V. Vene uela - airgrams on foreign exchange transactions

VI. Office of Intelligence Support - Treasury

VII. CIA

A. Trade and AID Branch - Jeff Flood: 351-5291

B. Trade and Monetary - Virginia Ehlebee: 351-7717

VIII. Germany - occasional report in Bundesbank monthly on German B/P with OPEC

Date: April 24, 1979

MEMORANDUM FOR: Assistant General Counsel Munk

From: Dirck Keyser CMM

Subject: OPEC Investment Information Requested by Subcommittee on Commerce, Consumer and Monetary Affairs (SRB-37)

Our preliminary analysis of the Treasury International Capital (TIC) data requested by the Subcommittee on Commerce, Consumer and Monetary Affairs in Chairman Rosenthal's April 10 letter indicates that we would need about three months to respond.

The data we would be able to deliver would be less than requested, since we do not collect all of them. Moreover, it is our understanding that we cannot legally deliver all of the data we do have. Instead of 13 country-breaks for all 13 OPEC members, for instance, we would provide five regional breaks, as follows:

Ecuador
Venezuela
Indonesia
Asian oil-exporters (Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates)
African oil-exporters (Algeria, Gabon, Libya, and Nigeria)

In conformity with our understanding of the legal protections due foreign official institutions, we would propose to meet the request for the positions of foreign official institutions by combining these data with those of unaffiliated foreign banks, as we usually do for Treasury Bulletin publication.

The specific categories of data requested by the Subcommittee are discussed below.

	Initiator	Reviewer	Reviewer	Reviewer	Reviewer	Ex. Sec
Surname	Keyser	Lee				
als / Date	JM / 4/24/79	/	/	/	/	/

1 08-3129
artment of Treasury

I. Investments in U.S. Government Securities, 1974-78

A. Type of Foreign Investor: we cannot provide this analysis, since the S Forms do not identify the type of investor, except for Memorandum I, which identifies transactions of foreign official institutions, which we do not release, as mentioned above.

B. Type of U.S. Government Security:

1. Marketable Treasury bills and certificates (no non-marketable certificates are held by OPEC member countries).

2. Estimated holdings of marketable Treasury bonds and notes (there are no non-marketable bonds or notes; we can only provide estimates, since our data on bonds are flow data and do not provide figures as to total holdings. Exact holdings figures will be available from the Foreign Portfolio Investment Survey (FPIS) for year-end 1978, probably in 1980).

3. Estimated holdings of bonds of U.S. Government corporations and Federally sponsored agencies (we have flow data, but no detail on the composition of these holdings, and thus could not separately identify GNMA, FNMA, and FHA securities; fuller detail will be available from the FPIS for year-end 1978, but not for the other years covered in the request, and probably not before 1980).

II. U.S. Banks' Liabilities to OPEC Countries, 1974-78

A. Type of Investor

1. Foreign Official institutions and unaffiliated foreign banks (foreign branch data, collected by the Federal Reserve Board, are not available in this degree of detail, and would be omitted)

2. All others (foreign branch data would be omitted)

B. Type of Bank liability

1. Deposits

a. Demand (omitting foreign branch data

b. Time (omitting foreign branch data)

2. Custody liabilities

a. Short-term Treasury Obligations (we do not collect data on banks' custody holdings of long-term securities; estimated OPEC holdings would be provided under Section I above; we would also not have any information on bank custody holdings of stocks and non-government bonds. There are no available foreign branch data)

b. Other custody liabilities (omitting foreign branch data).

c. Negotiable CDs (these data would be available for 1978 only, not having been separately collected on the old forms; foreign branch data omitted).

3. Other bank liabilities (foreign branch data omitted).

C. Concentration of American bank liabilities set forth above. We understand this to mean aggregate totals, rather than by details; foreign branch data could thus be included. The groupings specified by the Subcommittee would put particularly onerous burdens on our computer capabilities, which are already seriously overburdened by the demands of the New York Fed's normal operations, the Senate's foreign exchange survey, the FPIS, and our own normal operations. Since it is very unlikely that any bank will show more than 5 or 10 percent of its liabilities as due to OPEC countries, it is probable that categories 4, 5, and 6 will not be used. We may also have disclosure problems in the 5-10 percent range of category 3, since these may be only one or two banks in this category.

III. Investments in American Stocks, and other Debt and Equity Instruments

The Subcommittee requests both portfolio investment and direct investment, as well as investments held in nominee and custody accounts by brokers, dealers, and other non-banking concerns. Treasury does not collect direct investment, and would have to request these data from Commerce. We can make no estimate of the time required to obtain current data from Commerce. The portfolio data request largely anticipates the 1978 FPIS, which as noted above, will probably have results available in 1980. We can give estimates of holdings based on the data from the monthly S Form reports of stock and bond transactions with foreign residents. On this basis, we could provide the following:

A. Type of Investor: we cannot provide this analysis, since the S Forms do not identify the type of investor, except for Memorandum I, which identifies transactions of foreign official institutions, which we do not release.

B. Type of Investment

1. Stock: as noted, we have flow data, but must add these data to estimated holdings derived from past tabulations and adjusted (by Commerce) for market fluctuations. These data do not include limited partnerships, joint ventures, non-corporate businesses, real estate, or any other non-stock equity instruments.

2. Corporate, state and municipal bonds: our data do not distinguish between corporate bonds on the one hand and state and muncipal bonds on the other. The 1974 FPIS indicated that overseas holdings of state and municipal bonds were slight.

3. Other debt instruments: We are not sure what is wanted here. If the Subcommittee follows the pattern set by the 1976 Investment Survey Act, this could be interpreted to mean C Form data on firms' short-term liabilities to foreign residents. In the December 31, 1978 data, we will be able to distinguish between borrowings from foreign banks and extensions of trade credits by foreign companies, but this was not possible during the 1974-1977 years. Moreover, we have no data in this series for individual OPEC countries other than Venezuela and Indonesia prior to 1977, nor is maturity analysis possible

for 1978.

C. Concentration of equity ownership: this will be possible only when the 1978 FPIS results are available. Our regular monthly data do not identify the issuers of the stocks bought. We do not know whether Commerce can provide this analysis of direct investment.

IV. Non-bank liabilities:

We would have no data beyond what is specified above. Item IIIB3 would appear to cover this.

III

3. (c) There does not to our knowledge exist in our files any correspondence with the Bureau of Economic Analysis on access to data of individual OPEC countries. Attached is a copy of Official Use Only correspondence with the Central Intelligence Agency in which CIA requested and was granted such access.

V

Investments of non-OPEC nations in U.S. Treasury Securities, Year end 78

As noted above, we cannot provide data by type of foreign nvestor for long-term securities; however, these "presentations ould be compiled from existing EIS work-sheets.

VI, VIII, and IX

ments Relating to Effects and Consequences of OPEC Investments:

While we have not been asked for EIS studies in this ield, this Office has produced a great deal of work on he subject at various times from 1974 to the present. hese include studies of recycling by U.S. banks, effects f OPEC positions vis-a-vis the dollar, etc. The sheer olume of paper involved, together with the absence of any specific request for these documents, has caused us to omit them from this discussion, but should you think it necessary, they are available for inspection.

cc: Assistant Secretary Bergsten
Deputy Assistant Secretary King
Deputy Assistant Secretary Karlik
R. Hunt
R. Brown
L. Maley
G. Lee
J. Hamm
J. Kotze

BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

Changes Needed to Improve Government's Knowledge of OPEC Financial Influence in the United States

The bulk of OPEC holdings in the United States are or have been portfolio investments--dollars and dollar equivalents. Direct OPEC investment does not appear large and primarily is or has been in real estate and finance.

Government estimates of OPEC financial influence in the United States are likely to be underestimates. Small, private company, or third-party investments may escape attention; others have been misidentified in Government records.

In order to make the Government more aware of the extent and nature of OPEC financial influence in the United States, the Departments of the Treasury, Commerce, and Energy should improve their foreign investment monitoring efforts.

EMD-80-23
DECEMBER 19, 1979

86-722 0 - 82 -43

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

CHANGES NEEDED TO IMPROVE GOVERNMENT KNOWLEDGE OF OPEC FINANCIAL INFLUENCE IN THE UNITED STATES

D I G E S T

Whether large OPEC (Organization of Petroleum Exporting Countries) investments in the United States enhance the cartel's influence--financial and otherwise--on U.S. policy is a growing national issue. GAO's recent report "Are OPEC Financial Holdings a Danger to U.S. Banks or the Economy?" (EMD-79-45) dealt with OPEC monetary investments. This one focuses on the remaining forms of financial influence.

THE NATURE OF OPEC FINANCIAL INFLUENCE IN THE UNITED STATES

OPEC investments are large in absolute terms, but constitute only a small portion of total foreign investment in the United States. OPEC holdings in the United States are in excess of $62 billion. Over 99 percent are portfolio investments, particularly deposits in U.S. banks and purchases of U.S. securities. The other 1 percent of identified OPEC direct investments has primarily been in real estate and finance.

OPEC direct investments--those likely to yield the maximum influence--are less than 1 percent of total foreign direct investment in the United States, according to Government figures. None of these direct investments could be identified as a strategically placed investment in major U.S. companies or in sensitive industries. Furthermore, no OPEC government, with the exception of Kuwait, has indicated a desire to make large acquisitions in the United States.

GAO examined OPEC investments in U.S. banks and in energy companies. (See ch. 2.) As of October 1979, at least 13 U.S. banks had been partially purchased by residents of OPEC countries. Bank regulators have not identified any problems with these banks since their acquisition. The one OPEC energy investment identified by the Department of Energy is a non-fuel mineral exploration company operating in Saudi Arabia.

Financial influence can take forms other than those of conventional investments. Some U.S. universities have received contracts and grants from OPEC countries. But, overall, OPEC sources provide relatively little financial support to U.S. schools, and such funds as they do provide appear to give OPEC members no additional influence over U.S. energy policy. OPEC members' financial involvement in lobbying and public relations, while often conspicuous, remains small in comparison to the expenditures of many other foreign governments.

The Treasury and Commerce Departments compile data on OPEC holdings on a country-by-country basis. But, in most cases, they refuse to release important statistics to outside analysts, including the U.S. Congress. Treasury's position is that

> "* * * the International Investment Survey Act of 1976 forbids revealing the affairs of individual investors. Treasury cannot reveal totals of certain countries because they would reveal the affairs of individual foreign investors."

Stated in this manner, Treasury's position appears to be one of protecting the privacy of individual human beings. In fact, the Department is withholding information concerning massive transactions of official Government monetary institutions.

CONCLUSIONS

U.S. Government efforts to monitor foreign investment are diffuse and shared among Treasury, Commerce, the Department of Energy, the Securities and Exchange Commission, and other agencies. Because small or private investments may escape attention and because OPEC members often use financial intermediaries, U.S. estimates of OPEC holdings are likely to be underestimates.

On the whole, OPEC investments do not appear to be a threat to the economy. However, GAO is concerned that U.S. officials might not be aware, on a timely basis, if particular strategic investments were made to influence policy. (See ch. 4.) Furthermore, as current developments in Iran illustrate, situations can arise in which the United States might wish to change its strategies toward OPEC financial influence. In recent days, spokesmen for the Governments of Iran and the United States have given widely differing estimates of total Iranian investment in the United States. Events have reinforced GAO's conclusion that more detailed and current knowledge of OPEC and other foreign investment is needed.

Country data are not shared among agencies nor disseminated to all who need them, including the Congress. GAO has seen no evidence that the Government takes financial interdependence with the OPEC nations into account in formulating U.S. international energy policy. Improvements are needed in some Federal monitoring activities to improve the Government's awareness of the extent and nature of OPEC financial influence in the United States.

RECOMMENDATIONS

To the Department of the Treasury:

Unless the Secretary of the Treasury can demonstrate that the costs to both the Government and private business of additional reporting would be excessive, the Treasury should collect, on International Capital Form S, data identifying the sector and industry of equity purchases. This additional information would permit timely and regular identification of the areas of the

U.S. economy into which foreign portfolio investment, including that of OPEC, is flowing. This data should be published at least annually in a format similar to other published investment statistics.

To the Department of Commerce:

The Secretary of Commerce should determine how foreign beneficial owners could be better identified under current Bureau of Economic Analysis reporting requirements. Forms should, at a minimum, attempt to identify whether the reporting entity is itself a subsidiary of another foreign company or the beneficial owners of the reporting entity are nationals of a third country.

The Secretary should carefully examine results of the Department's next benchmark survey to see whether the magnitude of increase in foreign investments in businesses with income under $5 million warrants closer annual monitoring.

To the Department of Energy:

The Secretary of Energy should transfer the responsibility for the Department's monitoring of foreign investment in U.S. energy from the Office of International Affairs to the Energy Information Administration. Given the Administration's legislative mandate to collect, evaluate, assemble, analyze, and disseminate energy data and information, it is a more appropriate focal point for the Department's monitoring responsibility.

The Department should also collect primary source information on foreign investment by amending its financial reporting system to include questions on foreign sources of equity capital, loans, and joint ventures. This reporting system covers a much wider range of energy producing, processing, transportation, and technology companies than is presently monitored by the Office of International Affairs.

AGENCY COMMENTS AND OUR REVIEW

A draft of this report was circulated to the Departments of Commerce, Energy, and the Treasury; the Federal Reserve Board; and the Securities and Exchange Commission. The Department of Energy and the Securities and Exchange Commission were unable to prepare their replies in a timely manner. Those of the Department of Energy were received a month late; those of the Securities and Exchange Commission were not received at all. The Commission's viewpoint, therefore, has not been included. Agency comments are included as appendices IV, V, VI, and VII.

The Department of the Treasury fundamentally disagrees with GAO's statement that it is important to know on a reasonably current and continuing basis "who owns whom?" and "who is buying whom?" with regard to foreign portfolio investment in the United States. Treasury states that no evidence suggests that this investment, wherever it may occur, operates against the interests of the United States. Therefore, Treasury feels that the expense required to generate additional current information on this subject is unjustified. GAO believes that the existence or nonexistence of a clear and present danger is not the issue. Instead, GAO questions the ability of the executive branch to detect such a threat on a timely basis, should it occur.

The Department of Commerce maintains that the Bureau of Economic Analysis releases more data to interested observers than is published in regular Department publications. GAO found that the bulk of these releases have been within the executive branch. Detailed data on OPEC investments were not made available to GAO during the course of GAO's examination. Furthermore, GAO believes that the International Investment Survey Act of 1976 does not exclude congressional access to confidential information such as that collected by the Bureau.

The Federal Reserve Board generally concurs with Treasury's comments. GAO thinks that the Federal Reserve Board and the Treasury should analyze these costs in greater detail before dismissing GAO's recommendation.

The Department of Energy concurs with GAO's recommendation that responsibility for its monitoring of foreign investment in U.S. energy be transferred from the Office of International Affairs to the Energy Information Administration. The Department also points to the problems associated with the expanded financial reporting effort which GAO proposes.

B. MATERIAL ON THE MASSIVE STATISTICAL DISCREPANCY IN COMMERCE DEPARTMENT U.S. BALANCE OF PAYMENTS STATISTICS, INCLUDING UNIDENTIFIED CAPITAL INFLOWS INTO THE UNITED STATES

American Banker August 28, 1981

Secret Borrowing From Arabs Seen

WASHINGTON (UPI) — Americans trying to escape high interest rates may be secretly borrowing money overseas from oil-rich Arab countries, with a record amount of nearly $30 billion unexplained in 1980, government officials said Thursday.

The disclosure of the highest-ever $29.6 billion "statistical discrepancy" was included in a Commerce Department report on net U.S. international investment — the money Americans sent across the border over that which was returned by foreign investors.

The department said Thursday that by the end of 1980 American individuals and companies reported sending $122.7 billion more across the border for acquisitions and investments elsewhere than foreigners spent in the United States. The difference was $27.7 billion greater than in 1979.

➻ Secret: Page 15

Secret . . .

Continued from page 11

But the figures were clouded by the record $29.6 billion "positive unrecorded inflow" during 1980. Together with the smaller total of unexplained imported funds during 1979, at least $50.6 billion in money arrived in the United States withour being officially explained.

"Those are the two extraordinary years," said Commerce balance-of-payments specialist Russell B. Scholl. "We're dealing in a new era here," he added.

Mr. Scholl, a member of a government working group probing the possible sources of the imported money, ruled out illegal drug profits as the cause, saying the relationship "doesn't hold up."

Most illegal drug profits that move across the border do so in the opposite direction, Mr. Scholl said.

And illegal drug proceeds would not have suddenly peaked at the same time foreign borrowing became cheaper than domestic borrowing, he said.

Mr. Scholl said the timing of the surge in unrecorded foreign funds appeared to also be related to the Iranian crisis "which tended to direct OPEC money into areas that would be less evident."

At the same time U.S. borrowers were looking for cheaper money overseas, Arabs, disturbed by the Iranian upheaval, were looking for safe places to invest their funds, he said.

And the surge that was unreported closely resembled the increase that was officially reported as OPEC investments officially accounted for in the United States went up by $16.2 billion during 1980.

Mr. Scholl said that confusion over reporting requirements may contribute to the unreported total as well as his own department's limited ability to search every government document. "We can't be on top of every piece of public information. It would just drown us," he said.

In addition, the lenders overseas may not be aware they are required to report such transactions.

But the biggest factor, he said, is probably the desire of both lender and borrower to keep the investment quiet.

"Someone in the U.S. looking for a loan and a foreigner who has funds to lend would do so under a private contractural basis and there would be no public announcement," he said.

During 1980, U.S. assets abroad increased by $94.7 billion to $603.6 billion. Foreign assets in the United States increased $67 billion to $480.9 billion.

Purchases of stock in both directions set records during the year. ■

PROGRESS REPORT OF THE INTERAGENCY WORK GROUP ON THE BALANCE OF PAYMENTS STATISTICAL DISCREPANCY

JUNE 1981

STATUS REPORT ON THE BALANCE OF PAYMENTS STATISTICAL DISCREPANCY

The statistical discrepancy problem in the balance of payments accounts (BPA) is being addressed by the Interagency Committee on Balance of Payments Statistics. The Committee is chaired by the Office of Federal Statistical Policy and Standards of the Department of Commerce.

While the sources of the statistical discrepancy are spread throughout the BPA, the Committee felt that an important part of the recent rise in the discrepancy stems from the lack of adequate reporting of non-direct investment capital funds coming into the United States. Therefore, in September 1980 the Committee formed a Work Group to focus on this aspect of the BPA. Because statistics on these capital fund movements are obtained from the Treasury Department monthly data collection system on international financial transactions, the Work Group concentrated much of its efforts on indentifying recent market developments that might have led to under-reporting in the collection system.

The initial phase of the review indicated that the increasing tendency of U.S. companies to borrow from abroad because of lower interest rates there has led to ambiguities in reporting responsibilities of borrowers and lenders, and that some international financial transactions were not reported. The Treasury Department is now working on clarifying instructions to respondents on their reporting responsibility.

Attached is a copy of the "Progress Report of the Interagency Work Group on the Balance of Payments Statistical Discrepancy." It lists the Work Group members and also identifies areas for further research. The Interagency Committee reviewed the report in June 1981. The Committee concluded that the report recommendations were a constructive approach for dealing with the problem. It also modified the priorities for further research by giving greater importance to reporting by nonbank financial companies. The Work Group will continue in its efforts as recommended by the Committee.

Attachment

INTRODUCTION

This is a progress report on the findings of the Work Group established by the Interagency Committee on Balance of Payments Statistics that has been examining the problems and possible remedies associated with the recent sharp rise in the statistical discrepancy of the balance of payments accounts. The members of the Work Group are:

Norman Frumkin
Office of Federal Statistical
Policy and Standards
Department of Commerce

C. Dirck Keyser
Office of International
Financial Reports
Department of the Treasury

Russell B. Scholl
Bureau of Economic Analysis
Department of Commerce

Lois E. Stekler
Division of International
Finance
Federal Reserve Board

The report has three sections. The introduction provides background on the statistical discrepancy and the origin of the work group. The second is an interim analysis of problems in the reporting of international financial transactions. The third gives recommendations for improved reporting and further research.

Errors and omissions in the U.S. balance of payments accounts reflect the residual net amount of statistical discrepancy derived from compiling all recorded transactions between U.S. and foreign residents.

In the double-entry system of accounting for the balance of payments, the recording of transactions, in principal, consists of offsetting entries of equal values--credits (positively signed) and debits (negatively signed). For example, the value of a U.S. merchandise export is a credit entry and the value of foreign payments for them, in the form of a reduction in foreign holdings of U.S. dollars or in the form of U.S. loans extended to foreigners, is a debit entry. In practice, however, recording the multitude of complex international transactions rarely equates credit and debit entries; thus, there is usually some net residual measure of inaccuracy--the statistical discrepancy--to be considered in interpreting the balance of payments accounts. Because of a possible offsetting of errors between the credit and debit entries, the gross errors of credits and debits may be larger than the measured statistical discrepancy.

During the decade of the 70's the statistical discrepancy in the U.S. balance of payments accounts has shown both sharp swings and an upward trend. (See Chart 1.) In 1979 the discrepancy reached $24 billion in unrecorded net credits, and in the 1980 that understatement rose to $36 billion.

A large statistical discrepancy casts doubt on the reliability of policy and analytical conclusions based on balance of payments data. An empirical rule of thumb suggested by the International Monetary Fund is that a statistical discrepancy which exceeds five percent of the sum of the absolute values of merchandise exports and imports is cause for concern. In 1979 the ratio for the U.S. statistical discrepancy was six percent; and preliminary information indicates that it will be over seven percent in 1980.

Movements in the statistical discrepancy are generally assumed to reflect unrecorded capital flows. While there are undoubtedly inaccuracies in the reporting of current account transactions, particularly service items, the value of these errors and omissions presumably would not fluctuate widely from quarter to quarter.

Although the statistical discrepancy is usually interpreted as unrecorded capital flows, there has been little correlation over the last decade between the statistical discrepancy and recorded net private capital flows. Movements in net private capital flows and the statistical discrepancy have not been parallel over the last two years either. (See Table 1.) The explanation for the statistical discrepancy is not simply that a stable fraction of net private capital flows is unreported, since general forces such as exchange rate expectations or differentials between countries' interest rate levels would be expected to influence both recorded and unrecorded net private capital flows in the same direction. An explanation for the unrecorded inflows in quarters where net private capital flows and the statistical discrepancy move in opposite direction must be sought elsewhere, as for example, in factors that shifted the flow of capital from well reported channels to others that are less adequately covered by the balance of payments reporting system. Possible explanatory factors include changes in the structure of interest rates, U.S. government policies, or foreign asset holders' preferences.

The U.S. reporting system for international capital flows has two major components: (1) the reports filed with the Department of Commerce of transactions between direct investors and their foreign affiliates, and (2) the Treasury International Capital (TIC) reports. The TIC system includes three types of reports: the "B" reports of banks' own and custody claims and liabilities, the "S" reports of securities transactions and the "C" reports of corporate claims on and liabilities to unaffiliated foreigners (both commercial and financial). The Federal Reserve Banks collect the TIC data as the agent of the Treasury Department.

These reporting systems all have certain problems in common. Certain institutions may not deal with foreigners on a regular basis and therefore may be less likely to report or to report accurately. Within reporting firms, the persons responsible for filing the forms may be uninformed about new or unusual transactions. In addition, there may be ambiguities in reporting instructions, creating confusion about who is responsible for reporting certain transactions.

In response to the growing statistical discrepancy, particularly in the second quarter of 1980, an interagency Work Group was established in September 1980 to investigate the sources of the large recent statistical discrepancy. Attention was focused on recent financial market developments that might have led to a large increase in unrecorded credits. Consequently, members of the Work Group held a series of meetings with banks, corporations, and investment brokers in an attempt to identify such inadequacies in the balance of payments reporting systems.1/

1/Meetings were held with the following firms in November 1980 and January 1981: Morgan Stanley, Goldman Sachs, Mobil Oil, General Motors, Chase Manhattan, Morgan Guaranty, Salomon Brothers, National Westminster, RCA, Deutsche Bank, American Brands, International Telephone and Telegraph, Merrill Lynch International, Dai-Ichi Kangyo, Gulf + Western Industries, and W.R. Grace. Participants in the meetings included Norman Frumkin (Office of Federal Statistical Policy and Standards), Russell Scholl (Bureau of Economic Analysis), Dirck Keyser (Treasury), Lois Stekler and Michael Dooley (Federal Reserve Board), John Ruocco, Marie Collins and William Walsh (Federal Reserve Bank of New York).

Table 1. U.S. International Transactions
(billion of dollars, outflow = (-), not seasonally adjusted)

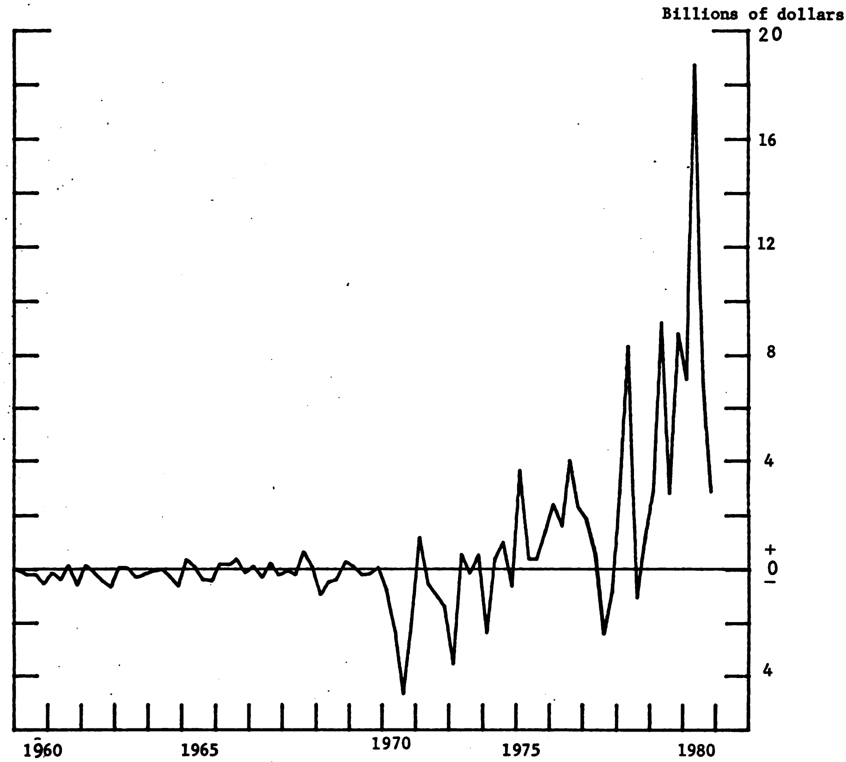
	1979				1980			
	Q-1	Q-2	Q-3	Q-4	Q-1	Q-2	Q-3	Q-4
Current account balance	1.7	-.1	-2.9	.6	-2.4	- .7	.1	3.1
Net private capital flows	7.7	1.5	-7.7	-6.6	6.2	-25.2	-12.5	-8.3
change in net foreign positions of banking offices in the U.S. 1/	13.2	4.2	-3.8	-6.8	6.1	-25.3	-12.1	-4.7
net private securities transactions 2/	2.4	.5	—	.2	4.9	-1.3	-.1	3.4
net flows reported by non-banking concerns	-2.9	1.5	- .3	1.5	- .8	1.5	.9	N.A.
net direct investment	-4.9	-4.7	-3.6	-1.5	-4.0	-.1	-1.2	-7.0
Net official reserve asset flows	-12.2	-9.8	8.6	-1.8	-10.5	8.3	6.9	3.3
increase ((-) in U.S. reserve assets	-3.6	.3	2.8	-.6	-3.3	.5	- 1.1	-4.3
increase (+) in foreign official assets in the U.S.	-8.7	-10.1	5.8	-1.2	-7.2	7.8	8.0	7.6
Other items	-0.1	-0.9	-0.8	-0.9	-0.4	-1.1	-1.4	-1.0
Statistical discrepancy	2.9	9.2	2.8	8.8	7.1	18.7	6.9	2.9

1/ Excluding liabilities to foreign official institutions.
2/ Including private foreign purchases of U.S. Treasury obligations.
N.A. - not available

SOURCE: Survey of Current Business, March 1981.

Chart 1

The Statistical Discrepancy in the Balance of Payments Accounts



Quarterly data from the Commerce Department.

ANALYSIS OF THE PROBLEM

While the overall problem of the balance of payments statistical discrepancy is complex and probably reflects a variety of errors and omissions, the evidence which the Work Group has been able to bring to light so far strongly suggests that a significant portion of the large unreported inflows of 1980, particularly in the second quarter, were associated with unreported Euromarket borrowings.

It seems likely that the Federal Reserve's credit restraint program made it hard for U.S. corporations to obtain funds for domestic use from their usual domestic banking sources. As a consequence, the companies probably turned to a significant degree to other channels, including Eurodollar markets, and obtained the required funds either from foreign banks or from the foreign offices of U.S. banks.

There has been a noticeable increase in foreign bank activity in recent quarters. Several of the firms on which we called in November and in January, including the banks, said that the foreign banks have been particularly active in soliciting American business, often offering loans at lower rates than those offered by U.S. banks. The sourcing of these loans is not always apparent to the borrowers.

Rates are quoted variously. Floating-rate pricing formulas are based on the prime rate, on the Federal Funds rate, on the London inter-bank offering rate (LIBOR), or on the "cost of funds". While more conservative banks are careful to match pricing and sourcing, so that loans priced at LIBOR are indeed booked in the Euromarkets, we found in one instance that loans are also priced at LIBOR and funded with New York certificates of deposit. Under the competitive pressure of the more aggressive foreign banks, these varying loan pricing packages are being offered also by the American banks.

An increasingly popular form of loan contract provides the borrower an option -- "either-or" financing -- by which a loan may be priced at some New York-based rate (prime and Federal Funds are the most common) or at LIBOR, whichever is lower. The borrower has the option to switch from the higher rate to the lower. Most contracts seem to provide for such switching at a three-month or six-month rollover date. We were told that a considerable amount of such switching took place during the second quarter.

We found that internal treatment of these different kinds of international borrowings varies considerably from bank to bank and from borrowing firm to borrowing firm. One major international borrower made no attempt to ascertain the source of the funds borrowed, and consequently was in no position to report such borrowings as required on the Treasury International Capital (TIC) Form CQ-1. It was generally clear that corporate treasuries were preoccupied with other concerns, and that reporting details were left to lower-ranking personnel in the corporate controller's departments.

Since many of the loans thus booked abroad, either as straight Eurodollar market loans or as "either-or" borrowings, are serviced by the New York banking offices on behalf of their foreign offices, the point that a given loan is in fact booked in Nassau or London may totally escape the controller's bookkeeper who services the loan or who fills out Form CQ-1, and the TIC reporting responsibility may thus be overlooked. One firm we visited told us quite frankly that they had, on investigation, found a number of such borrowings on their books — foreign borrowings treated as domestic ones, and so not reported.

Thus, there is an ambiguity in reporting responsibility resulting in the lack of reporting by both "B" and "C" form reporters. This requires that the reporting responsibility of the two groups be stressed and clarified.

A partial solution to this problem may lie in an alteration of the TIC Form BL-2 reporting instructions to make clear to banks holding notes for such loans on behalf of their foreign offices that the items are reportable in column 6 of Form BL-2 as "other custody liabilities", that is, custody items not otherwise identified on the form which represent claims of foreigners on U.S. residents. This reporting responsibility is already stated in principle in the General Instructions, Paragraph B, "Who must report".

Such a clarification of the instructions would have to take account of the fact that in some lines of credit, individual drawings on such lines of credit are not evidenced by the borrower's giving a bank a note, so that there is in fact no note held by the U.S. office for the account of the foreign office. In most such cases, however, it is our understanding that while the U.S. office does not require an actual note for each take-down, and does agree to such drawings on the telephone, actual crediting of the customer's account based on such a telephone conversation does not take place until the call has been confirmed by letter or telex. In such cases, the lending institution's evidence of the customer's borrowing is the letter or telex message.

Another complication for this BL-2 approach is introduced by the fact that in most cases, the U.S. office receiving a note from the borrower apparently does not hold it in physical custody for the foreign office, but mails it onward. Since most such notes mailed abroad do pass through the hands of the foreign banks' U.S. office, however, it might be possible to require the U.S. office to report on such notes remitted. The problem with this approach is that it might not be possible to track repayments of such borrowings.

For foreign borrowings which are clearly not treatable by this BL-2 approach, it would be necessary to improve CQ-1 reporting by the non-banking companies. One avenue would be a circular letter to all CQ-1 reporters drawing their attention to the problem and attempting to clarify reporting responsibility.

Our review of the statistical discrepancy problem has highlighted the growing use of international banking facilities by U.S. corporations. It should thus be noted that this use is (and increasing will be) reflected in the item now presented in the Survey of Current Business (SCB) balance of payments data, Table 9, line 20, "Banks' custody liabilities, payable in dollars." These data should normally be added for analytical purposes to those collected from corporations on the TIC "C" form and published in Table 7 of the SCB balance of payments data.

We have considered the possibility that some of the Eurodollar market borrowing by U.S. firms is being done by the foreign subsidiaries of U.S. non-banking firms, and used to generate financial flows to the parents which are not being picked up by the Bureau of Economic Analysis (Department of Commerce) direct investment forms. The general view of the Work Group is that there is little likelihood that the unreported amounts of such flows can be very large.

We have also examined the possibility that large unrecorded inflows may have come in through the securities markets, which are covered by TIC Form S. The 1978 Foreign Portfolio Investment Survey has yielded a figure for U.S. stockholdings so close to that derived from the Form S data that it does not appear that significant flows can be escaping this reporting form. The reporting of private placements of debt securities on the S Forms, however, may require some attention.

It does appear that flows through the commodities markets may bear closer examination; one major brokerage firm told us in January that their commodities commissions now equaled their securities commissions, and have quadrupled in the past four years.

RECOMMENDATIONS
(in order of priority)

1. In order to improve the coverage of U.S. firms' Eurodollar borrowings from overseas banks, it is necessary to clarify reporting responsibility and instructions and to broadcast these reporting requirements to firms engaged in that activity. The Treasury Department has already begun to modify the instructions of their TIC forms and to prepare an announcement to firms that transactions of that nature are reportable. The Work Group feels that these reporting alterations should be made applicable back to December 1979 in order to alleviate some of the statistical discrepancies in the second quarter of 1980.

Because of the broadening international character of U.S. firms' financing, it appears that this source of funding will continue in importance. It will thus continue to be necessary to monitor developments in this market and to be alert to the possible need for changes in reporting procedures.

2. While the Work Group did not explore the problem of trade credits in depth, it is evident from Treasury Foreign Currency data that there was substantial leading and lagging during the second quarter of 1980. At least one highly competent bank economist suggested exploration of this area. Federal Reserve flow-of-funds data suggest unusual patterns of domestic trade credit in the second quarter. The Work Group believes it should investigate this field more fully. One step the Group suggests taking is contacting U.S. firms that are large exporters, importers, or direct investors to ascertain if there are evident discrepancies either in their direct investment reports (if direct investment associated), or in the commercial reporting on TIC forms which depict relatively small shifts in trade financing in reported data.

3. As noted in the report, the Work Group feels that attention to the reporting of private placements would be useful. The second quarter was also a period of unusual bond market activity. The Group considers additional consultation with investment bankers specializing in these markets may uncover reporting problems.

4. Trading in commodity (and financial) futures and the concurrent growth in foreign involvement were repeatedly raised by those interviewed in the investment houses as a new dynamic growth area. The Work Group has been informed by the Bureau of Economic Analysis (BEA) of the latter's efforts underway to estimate this area of omission in the international transactions data. Any further exploration by the Group will be based on the outcome of BEA's work .

Longer-term

5. While the Work Group has not given attention to the real estate market in its interim report, a number of observers contacted in November and January felt that there have been significant inflows of foreign funds into this market. The Committee may want to consider an investigation of this market.

6. The Work Group did not find much evidence of large inflows into limited partnership interests. However, this is a market not well known to the Work Group's members, and it may be worthwhile to explore it further, particularly with respect to real estate.

7. The Committee is reminded that all of the Work Group's efforts have been directed to the study of the non-direct investment component of the capital account. A study of the current account might also prove useful. In addition, a review of the direct investment reporting in the context of the statistical discrepancy problem might be fruitful.

~~J. KARLIK~~
D. CURTIS
T. LEDDY

to

Department of the Treasury
Assistant Secretary
(International Affairs)

room: 3221 date 3/24

This is ridiculous. Do we have any idea what is causing this? Can any new research help?

C. Fred Bergsten
room 3430
phone 566-5363

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to: Don + Tom

Department of the Treasury
Deputy Assistant Secretary for International Economic Analysis

room: date: 24 March 80

I called Jack Bame at BEA about this. He is sending over an analytical piece on the discrepancy which I will pass along. Then we can confer as how to pacify Fred.

John

John R Karlik
room 3221
phone 566-5828

Inter-Office Memorandum

ACTION BRIEFING INFORMATION

Date: March 20, 1980

For Secretary's Daily Report

From Donald W. Curtis DWC

Subject. Balance of Payments Results for Q4 and Year 1979

Today's B/P release by Commerce shows, on current account transactions:

-- a near-zero deficit of only $300 million for the year 1979, compared to $13.5 billion in 1978; and

-- a Q4 deficit of $900 million, seasonally adjusted, following a cumulative Q1-Q3 surplus of $600 million (revised).

The trade deficit for the year was $29.5 billion -- down $4.3 billion from 1978 despite a $17.7 billion increase in oil import costs. The surplus on net invisibles was $29.1 billion, nearly $9 billion larger than 1978. This reflected a $10½ billion gain on net investment income partially offset by a $1½ billion worsening of net military transactions.

On the capital account side, the most notable single feature of today's results was an extremely large residual "inflow" under the Statistical Discrepancy.

-- The Q4 balance on all reported official and private capital transactions was a net outflow of $12½ billion -- which was, in effect, "financed" by a statistical-discrepancy inflow of $11½ billion (plus a small surplus, before seasonal adjustment, on current account).

-- For the year 1979 as a whole, the reported net outflow of official and private capital was $29½ billion, "financed" by a $28½ billion statistical-discrepancy inflow plus a $1 billion allocation of SDR's from the IMF.

	Initiator	Reviewer	Reviewer	Reviewer	Reviewer
Surname					
Initials/Date	/			/	/

OS F 10-01.2 (6-77) which replaces OS 3275 which may be

0403

A note on the statistical discrepancy in the international accounts

-- Jack Bame*

Analysis of U.S. international transactions for 1979 is markedly hindered by the very large positive statistical discrepancy (errors and omissions). In this note, there is a brief discussion of the nature of the discrepancy; a review of the large past discrepancies, together with the international economic and financial conditions under which they occurred; and finally, some brief comments on what steps might be taken to reduce the magnitude of the discrepancy.

* * * * *

<u>The nature of the discrepancy</u>

In balance of payments statements, the double-entry bookkeeping system is used by convention: every transaction recorded should involve a pair of entries, one designated a credit (+), the other a debit (-), so that the net balance of all entries should be zero. In practice, this is not always the case and there will be a residual net credit or net debit. The statistical discrepancy -- or net errors and omissions -- is shown separately as a balancing item, of equal value with opposite sign.

*Associate Director for International Economics
Bureau of Economic Analysis
U. S. Department of Commerce

There may be cases where the receipt side of a transaction involving goods, services, or capital is recorded and the payment is not, or vice-versa; in some instances, there may be valuation differences between receipts and payments; in others, receipts and payments may be recorded in different time periods (probably limited to from one month to six months), leading to a short-term discrepancy but one that will tend to be reversed when the delayed side of the transaction is recorded. Net errors and omissions, in these cases, arise because the credit and debit sides of the transactions involved are reported independently of each other.

It should be stressed that the statistical discrepancy is entered as a residual in the accounts on a net basis. Because some errors and omissions in particular accounts will offset one another, the size of the residual is not necessarily a reflection of the accuracy of the international accounts as a whole.

Historical Summary

From 1930 until 1960, the statistical discrepancy never exceeded $1.5 billion and was large, relative to the value of recorded transactions, only in periods of war or international post-war currency changes. Large movements in the residual tended to occur during periods of international financial economic and/or political instability. Also, the residual tended to continue in the same direction for several consecutive years.[1]

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1. See The Balance of Payments Statistics of the United States - A Review and Appraisal ("Bernstein Report"), April 1965, pp. 85-6.

Although the discrepancy remained within the same numerical range in the 1960's, there was a marked shift from continuous net receipts in the 1950's to net payments in all but 2 years of the 1960's. The resurgence of the leading foreign industrial nations, their return to currency convertibility, controls on U.S. direct investment and bank lending abroad, and the less dominant role of the United States in the world economy -- together with a fundamental worsening of our international competitive position -- all probably contributed to this change.

By 1971, these longer-range trends; the incompatibility of the cumulative rise of dollar liabilities to foreigners and decline in U.S. official reserve assets with the existing exchange rate structure and dollar convertibility; and more immediate unfavorable interest rate and cyclical gaps between the United States and other leading countries, led to widespread expectations of changes in currency values. There was, as a result, a heavy movement out of dollars into other currencies, almost $10 billion of which was unrecorded in 1971. The suspension of dollar convertibility into gold and the beginning of managed floating rate arrangements for most leading currencies -- which were to persist, with periods of heavy official intervention and wide swings in exchange rates, throughout the 1970's -- set the stage for a continued large net statistical discrepancy for most of the remainder of the decade.

There were continued large -- but much less so than in 1971 -- net outflows on errors and omissions through 1974, totaling almost \$6.5 billion, reflecting continued exchange rate uncertainties and pressures on the dollar. The quantum jump in international oil prices in 1973-74 seemed to have no immediate impact on the statistical discrepancy, in part due to cooperative efforts [illegible] and several petroleum companies that resulted in improved reporting and accounting procedures. In 1975 and 1976, there were net inflows on errors and omissions totaling almost \$15 billion, a period during which the dollar generally appreciated against most leading currencies. Also, there were serious political troubles in several European countries, during a period of little or no recovery from the 1973-74 "oil shock." These inflows just about offset the 1971-74 outflows. A temporary reversal to a net outflow of about \$1 billion occurred in 1977, followed by a return to record net inflows in 1978 and 1979, totaling almost \$40 billion.

The 1978-79 discrepancy

Given the volatility of the international economic, financial and political environment during the 1978-79 period, one might have expected a rise in the discrepancy, with a case to be made that former "reasonable" magnitudes[2/] should be increased to allow for the effects of the marked expansion in the volume of U.S. international transactions and of the acceleration of worldwide inflation. However, the magnitude of the discrepancy in 1979 is uncomfortably large by any standard and reflects upon the reliability of the international accounts.

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2. For instance, a \$1 billion discrepancy was considered by many observers to be "normal" in past years. Also, according to the International Monetary Fund's Balance of Payments Manual, 4th Edition..."An empirical rule of thumb that is sometimes quoted holds that a residual is large enough to create a problem when it exceeds the equivalent of 5 per cent of the gross credit and debit entries for merchandise combined (although the residual can also arise, of course, from nonmerchandise transactions)."

There was at least some tenuous link during much of 1978 between net errors and omissions and the magnitude and direction of U.S. trade, current account, and capital flows. There was, in addition, some correlation with exchange rate movements, although the fact that quarterly exchange rate changes sometimes masked intra-quarter developments does not make this immediately evident (the dollar's strength in April, May and November, for instance). However, in 1979 not much of a relationship between the discrepancy, the international accounts and exchange rate developments, appears to be in evidence, with some intra-quarter exceptions -- i.e., the dollar's firmness in the first part of the second quarter, and it's rebound early in the fourth quarter, both periods of large unrecorded inflows. More often, large net inflows on errors and omissions occurred in the face of general decline of the dollar against most leading currencies. The exceptional 23 percent appreciation of the dollar against the Japanese yen probably was a contributing factor to large unrecorded inflows attributed to Japan,[3/] particular in the fourth quarter. Also, international developments related to international political developments -- those in Afghanistan, for example -- probably resulted in large unrecorded inflows to the "safe" United States.

There were also very large unrecorded inflows attributed to "Other countries in Asia and Africa", which includes OPEC members.[3/]

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3. It should be emphasized that the attribution of unrecorded inflows to these areas does not imply that they represent unrecorded inflows to the United States. Rather, they largely reflect transfers of funds between these areas and other foreign areas.

Avenues towards possible data improvements and limitations

The following represent only a few selective possibilities for examination which might lead to improvements in the international accounts and, possibly, a reduction in net errors and omissions.

1. With Japan, efforts should be initiated -- and resources committed -- prepare for bilateral trade, current account and eventually capital account reconciliations, with the U.S.-Canadian reconciliation serving as the model. For instance, it is known that certain transactions counted as merchandise imports by Japan, involving leased equipment, prepayments for commodities, etc., are not reported by the United States as exports to Japan. Instead, the appropriate credit is or should be entered in the capital accounts, but this may not be effected in some cases. Also, efforts already underway to improve reporting on direct investment-related transactions -- including those with Japanese trading companies -- should be reinforced, as should monitoring and/or improvements in reporting forms of and coverage by other government agencies, particularly in the securities and banking areas.

2. With Asia and Africa OPEC members, where there has been a continued increase in the statistical discrepancy in recent years, there is probably much more room for improvement than prospects for better statistics, at this juncture. Here, it is possible that most of the discrepancy is accounted for in the non-direct investment capital accounts -- banking and securities transactions -- probably mostly reflecting transfers of funds between OPEC and other foreign areas, and to a much smaller extent, the use of U.S. residents (who may not report the name of the ultimate foreign transactor), as intermediaries for transfers to funds to the United States. Also, reporting has probably lagged or is incomplete in the very rapidly growing field of services transactions -- in construction, engineering, and other fields related to economic development projects, particularly in countries such as Saudi Arabia.

3. Efforts to improve monitoring of merchandise trade transactions should be reinforced to reduce the undercounting of U.S. exports, i.e., there have been instances of non-recording of container shipments from certain ports, etc. Similar improved surveillance and reporting involving big-ticket military shipments also would be helpful.

* * * * *

The above merely suggest some initial possibilities to consider with the objective of reducing the statistical discrepancy in the U.S. international accounts. Some additional observations may be in order: 1) if the net statistical discrepancy does shrink, it may be a matter of luck, rather than substance, in that errors and omissions in particular accounts offset each other; 2) the United States is not alone in posting a discrepancy in the international accounts -- other countries have their "balancing item" (U.K.) and "balance of statistically unclassifiable transactions" (West Germany). So do the International Monetary Fund and Organization for Economic Cooperation and Development (OECD) on a global basis, spotlighting the international asymmetry involved. (The OECD, for instance, imagination, combined with figures diligently arrived at, are gravely used in subsequent publications".

is concerned with the growing discrepancy in the international transportation account probably partly related to the utilization of flags of convenience, etc.) 3) Reporting systems tend to lag behind actual developments; innovations in methods of conducting international business, the introduction of new national and international financial instruments, technological and other innovations in methods of shipment (containers, etc.), in communications, and in international banking, all occur without waiting for statistical reporting requirements to change; 4) when reporting changes are effected, they often result in errors and/or misunderstandings on the part of reporters and make it difficult to maintain consistent time series for analysis; 5) accelerated and differential rates of inflation worldwide, and international economic, financial, and political instability, create an environment within which exchange rates fluctuate widely, interest rate changes tend to be wider than under normal conditions, and uncertainties grow, leading to large swings in recorded and unrecorded capital flows that are less responsive to basic cost-profit considerations than to more speculative and/or preservation-of-existing-capital orientation; 6) until (if) a more stable environment does (not) evolve, it would not be realistic to expect a quick or substantial reduction in the statistical discrepancy in the international accounts. This is not to imply that some of the latter certainly are more reliable than others, and improvements are sorely needed.

The international transactions statistics may not be quite as faulty as Oskar Morgenstern once noted, but his words bear attention:..."Any one who has ever sat through meetings (as the author has) in which final balance of payment figures for most invisible items were put together, can only marvel at the naiveté with which these products of fantasy, policy, and

Tom Leddy
to Dan Ciuriak

Department
of the Treasury
Deputy Assistant
Secretary for
International
Economic Analysis

room _____ date 26 Mar 82

The attached review of statistical discrepancy seems entirely reasonable to me. As Jack commented on the phone, "If we spent $1,000,000 and devoted 50 analysts to this problem, it still wouldn't go away."

Your comments + reactions are welcome. Is Jack's pessimistic assessment of the prospects for cooperation with OPEC to improve reporting realistic?

John

John R. Karlik
room 3221
phone 566-5828

Prepar. by

John Karlik

FROM:

ACTION

☐ NOTE AND FILE	☐ FOR YOUR [illegible]
☐ NOTE AND RETURN TO ME	☐ FOR YOUR [illegible]
☐ RETURN WITH MORE DETAILS	☐ FOR YOUR [illegible]
☐ NOTE AND SEE ME ABOUT THIS	☐ FOR YOUR [illegible]
☐ PLEASE ANSWER	☐ FOR [illegible]
☐ PREPARE REPLY FOR MY SIGNATURE	☐ SIGNATURE
☐ TAKE APPROPRIATE ACTION	☐ INVESTIGATE [illegible]

COMMENTS:

[illegible]

C. DISCUSSIONS ABOUT MAJOR GAPS IN REPORTING OF SAUDI ARABIAN AND OTHER MIDDLE EAST OPEC COUNTRY FOREIGN ASSETS/SURPLUS STATISTICS

Doc. No. 15

SUMMARY OF DOCUMENT FURNISHED BY
U.S. EXECUTIVE BRANCH AGENCY

A State Department document notes that official statistics released by the Saudi Arabian Monetary Agency in March 1978 show that the foreign assets of the Saudi Government, as reflected by the official assets of SAMA, reached slightly over $60 billion by November 3, 1977. The Department estimated that this would mean a year-end figure of approximately $62.5 billion, representing an increase of about $10 billion during 1977.

The Department noted that USG analysts had predicted a Saudi current account surplus of $21 billion for 1977 and could not, from the limited figures available to them, identify offsetting movements in the capital account which would explain the gap between the U.S. estimates of current account surplus and the reported additions to SAMA's assets.

SAMA's estimate of a $13 billion current account surplus in 1977 better correlates with the $10 billion increase in SAMA's foreign assets plus the $600 million we estimate for increased foreign assets of Saudi banks and an increase of about $1 billion in Saudi private investment abroad. Important in understanding SAMA's low figure for its current account surplus is the fact that SAMA includes all government aid payments abroad in its current account figures. It is doubtful, however, if government aid transfers could account for the entire $8 billion discrepancy between USG current account figures and SAMA's.

One knowledgeable expert notes that SAMA officials have consistently questioned U.S. and other Western estimates of Saudi current account surpluses. They believe Western observers consistently overestimate Saudi revenues and underestimate service payments, private transfers, government expenditures abroad and other outflows. Western analysts are unable to make detailed comparisons because SAMA does not make available current figures. SAMA officials say, however, that they have convinced the IMF of the correctness of their figures.

Doc. No. 23

SUMMARY OF DOCUMENT FURNISHED BY
U.S. EXECUTIVE BRANCH AGENCY

A State Department document dating from Spring of 1978 cites the following views of an experienced analyst of the economy of an important Middle Eastern OPEC country:

It is hard to determine what the government is spending and it is frustrating not to be able to get useful statistics from the government involved. It is clear that some ministries are not spending up to their allotments, even now, though their ability to spend has gone up dramatically over the past two years. Some ministries are doing better, probably taking leftovers from the others. One official has said that expenditures were about 90% of the budget. Another senior official has said that expenditures are still higher -- about or even over 100%. The latter appears to be counting total government expenditures, including the supplemental budget, because he was talking in terms of actual disbursements.

The country is spending, but not spending itself into deficit. Oil prices seem likely to rise enough in the coming years to avoid that.

Even if the rate of spending (and consequently, imports, government expenses abroad, aid payments, etc.) is going up faster than some analysts believe, that fact is not enough to explain the apparent gap between foreign exchange revenue on the one hand, and expenditures plus reported official asset increases.

One possibility: some of the oil earnings do not reach the government revenue stream but they are spent on imports or services, so it shows up on the accounts. Another possibility is the commercial banks' purchases of foreign currency, for which there are no figures. Also, the government talks of wanting to encourage private investments overseas, but has no statistics which it will share with us (what they have is not that good and six months late anyway). Private capital outflow on the scale which may be indicated, if true, seems very large.

NOTE: THIS DOCUMENT WAS FROM TREASURY'S OFFICE OF INTERNATIONAL BANKING AND PORTFOLIO INVESTMENT, DATE OF ATTACHMENT 7/18/78

Hidden Saudi International Reserves

ISSUE: The level of Saudi international reserves reported in International Financial Statistics by the IMF is substantially below estimates of total Saudi foreign assets. What is the reason for the sizable discrepancy between estimated Saudi foreign assets and published figures on their reserves? Why does the IMF tolerate the under reporting? Why are the Saudis trying to hide the extent of their foreign assets?

ANSWER: Comparison of estimates of cumulative current account estimates for the Saudi Arabian economy with their international reserves is to mix apples and oranges. The concept of international reserves is significantly different from the concept of current account balances.

International reserves are, conceptually, the level of certain types of resources by national authorities as a reserve fund for external payments contingencies. The level of a country's international reserves need not reflect total foreign assets of a government or the net international investment position of a country. For instance, U.S. official reserve assets at year-end 1976 totaled $18.7 billion while total U.S. Government assets abroad amounted to $64.7 billion with U.S. private assets abroad totaling $282.6 billion. The net international investment position of the U.S. (total U.S. assets abroad less foreign assets in the U.S.) amounted to $82.5 billion.

We have no reason to believe the Saudis (or any other country) are under reporting reserves to the IMF.

TREASURY DEPARTMENT

Document E-11 November, 1977

SUMMARY OF TREASURY DEPARTMENT MEMORANDUM

TO: A High Level Treasury Department Official

FROM: A Treasury Official

SUBJECT: Possible Diversification by a Middle East OPEC Country Out of Dollars

A Middle East OPEC country is not currently diversifying its foreign exchange holdings out of dollars into other currencies, nor does it seem likely to do so any time in the near future. Sources which analyze the Middle East OPEC country's financial posture (including three Federal agencies * * *) concur that the situation of this Middle East OPEC country is almost identical to that of another Middle East OPEC country.

Basically, the Middle East OPEC country has such a large portfolio that the dollar market presents the only viable outlet for these funds. It does, of course, have other than dollar-denominated foreign assets, and with the appreciation of the yen and the deutschemark the pace of their investments in these segments may accelerate somewhat; however, the bulk of their investments will remain in dollars, since investment opportunities elsewhere are limited.

* * *

* * *

Data supplied to the Treasury Department by banks and brokers in the U.S. show that the Middle East OPEC country has maintained a steadily rising level of dollar-denominated foreign reserves. Between June 1976 and August 1977, they had risen * * * *. The Middle East OPEC country also supplies these figures to the IMF for monthly publication in <u>International Financial Statistics</u>, but their figures appear to be greatly understated. * * * *. Treasury figure for the dollar-denominated portion <u>alone</u> of the Middle East OPEC country's foreign exchange reserves was * * * the Middle East OPEC country's figure for total foreign exchange reserves. By January 1976, our dollar-denominated figure was * * * than the total international reserves reported by the Middle East OPEC country. Knowledgeable persons have told us that most OPEC countries, including the Middle East OPEC country, do not give them a breakdown of the types of foreign exchange reserves which they hold; however, it is their opinion that these countries have been under-reporting their holdings for political purposes. Our figures seem to provide substantial evidence for this assumption.

* * * Throughout 1976 and early 1977, there was a precipitous rise in short-term (demand and time) deposits; these have since dropped back to what appears to be a more normal level (December 1975, * * million; up * * to * * million in April 1977; back down * * to * * million; up * * to * * million in August 1977). The investments of the Middle East OPEC country in Treasury bills followed a similar peaking pattern at about the same time, while investments in Treasury bonds and notes * * up from * *, U.S. agency bonds * *, up from * *, and U.S. corporate bonds * *) have been slowly and steadily growing over the past two and a half years. Investments in corporarate stocks have grown most rapidly (up * * billion).

One final item to note is that the OPEC countries have recently started discussing the possibility of accepting payments for oil, or designating the price of oil, in something other than U.S. dollars (either "OPEC dollars," SDR's, or other foreign currencies). The consensus is that ultimately the price of oil will be designated in a unit other than dollars which has an automatic adjustment mechanism in it, but that generally payments will still be made in U.S. dollars. Other currencies may be accepted, but again, since those markets are so limited in investment opportunities, the OPEC nations would incur additional costs in changing those currencies back into dollars for reinvestment. By accepting payments in U.S. dollars they will avoid these additional costs, while at the same time the pricing mechanism will adjust the actual number of dollars paid to the appropriate level in view of the dollar's current value.

Office Correspondence

Date September 26, 1977

To Mr. Volcker

Subject: Saudi Reserves and Their Disposition.

From P.A. Revey
Developing Economics Division
International Research Dept.

Copies To: Mr. Timlen, A.R. Holmes, Fousek, Pardee, Willey, Thunberg, Mrs. Ehrlich, Messrs. Frydl and Feder.

STRICTLY CONFIDENTIAL--TREASURY/F.R.

The Question of Saudi Reserves

Saudi Arabia's surplus funds continue growing but their actual size and disposition are a matter of some mystery and controversy. The absence of complete, timely and publicly available balance of payments statements plus the uncertain distinction between international reserves and other officially held foreign assets have led to suggestions that the Saudi Arabian Monetary Agency (SAMA) -- which superimposes the functions of an investment authority on those of a central bank -- is disguising the true size of the country's reserves for political reasons. The most sensational, and unfounded, argument asserts that a secret U.S.-Saudi arrangement, committing the Saudi authorities to invest a substantial proportion of the incremental surplus in non-marketable U.S. government securities, has produced a large discrepancy between the IFS figure for Saudi international reserves and the separate but larger IFS figure for SAMA's reserve assets. The fact that the difference between these two items was accounted for by the addition last February of a new line "Sama Other Assets" to the Saudi IFS data has hardly slowed the barrage of comment. Some on-going controversy is inevitable, however, as long as (1) the size of Saudi reserves continues to be regarded as potentially embarrassing; (2) as long as the composition of SAMA's investments remains publicly unavailable (concealing, for example, the fact that Saudi Arabia's U.S. government holdings are comprised solely of marketable securities); and (3) as long as the nature and strength of U.S.-Saudi mutual political interests remain subject to speculation and distortion.

Unlike most countries which define international reserves to include a wide variety of official claims on foreigners usable in the event of a balance of payments deficit, Saudi Arabia's reserves

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Note: Some data of this memorandum were compiled from Treasury Foreign Exchange Reports and from information supplied by the Foreign Operations Division of this Bank's Foreign Department. The Treasury may be extremely sensitive to these data being made available even to high officials of this Bank or to members of the Board of Governors since such access is not explicitly included in the existing access "agreement" with the Treasury. The Treasury is particularly sensitive to the release of data that are highly concentrated at one respondent, as are most of the figures in this report.

are narrowly construed. Apart from its gold holdings and IMF reserve positions (including lending to the Oil Facility), Saudi reserves consist of foreign exchange defined as bank deposits encompassing bank reported short and long-term deposits, repurchase agreements and other trade-related credits. Virtually everything else falls under the heading SAMA Other Assets -- namely investments in short and long-term government securities; corporate bonds and equities; bilateral aid to developing countries; loans to international and regional institutions; World Bank bonds; and loans to industrial country' governments and public authorities.

Broadly speaking, then, Saudi international reserves consist of highly liquid bank placements whereas other foreign assets, except for U.S. Treasury bills, are of a medium and longer-term character. Saudi Arabia's exclusion of U.S. Treasury bills, and presumably also short-term claims on other governments, departs from the commonly understood, although net uniform, definition of international reserves. The addition of Saudi U.S. Treasury bill holdings on its foreign exchange reserves would raise the end-1976 international reserve accumulation by bringing the total to . Moreover, many governments also choose to include in their reserves officially held long-term claims on official institutions. Under this broad definition, Saudi international reserves would be even higher, approaching the largest of any country in the world.

Reliable but largely unpublished information from U.S. Treasury Foreign Exchange Reports and data provided by Saudi authorities to international institutions such as the IMF and the United Nations provide a good though incomplete picture of Saudi external assets. After adjusting for the capital transactions of the oil sector,1/ Saudi Arabia's recent current account surplusses are broadly reflected in the growth of SAMA's foreign assets, which rose in 1974, in 1975 and about last year to reach by end-1976 -- equivalent to nearly 40 per cent of OPEC's total external official holdings. Although these assets are in principle, the sum of "International Reserves" and "SAMA Other Assets" (see Table 1), the tabulation is not exact owing to technical reporting differences: whereas international reserves are compiled on a Gregorian calendar basis, SAMA's foreign assets are reported according to the Saudi Hijri lunar year. Reporting discrepancies can be large because Saudi Arabia's (now $3 billion) monthly oil income is not received continuously but in a single lump-sum payment, usually on the 15th day of he each month.

Investment Patterns

There has been a discernable evolution in the disposition of Saudi Arabia's official foreign assets over the last two years, as indicated by Table 2. The investment pattern since 1974 reveals the

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1/ Oil sector capital adjustments comprise the difference between the current value of oil exports on an accrual basis and the corresponding cash receipts as well as compensation payments to oil companies for nationalization of oil facilities.

following changes: (1) a notable lengthening in maturity structure away from the initial concentration in highly liquid assets; (2) a shift in asset composition, with greater emphasis on longer-term government securities and corporate bonds and equities; (3) greater geographic diversification of holdings particularly into the U.S. market, associated with decreasing Euromarket placements; and (4) increased flows to developing countries, partly reflecting the growth in Saudi Arabia's institutional lending capacity. These trends reveal that secondary recycling of the Saudi surplus, especially via commercial banks, is on the decline now that Saudi authorities have begun to invest directly a greater share of the country's funds in purchases of government securities, loans to quality corporate borrowers and in assistance to developing countries.

Less than one half of Saudi Arabia's external assets end-1976 were held as foreign exchange deposits, compared with more than two thirds in 1974. Bank placements in the United States now account for 13 per cent and U.S. bank branches abroad make up another 34 per cent of the total foreign exchange holdings, according to end-1976 data. The remainder is presumably held as Eurocurrency deposits by BIS-member country banks, as SAMA is known to place deposits only with top international banks on an 'approved list' and to confine its investments to the noncommunist world. In contrast to the decline in highly liquid placements, medium and long-term investments have increased, with SAMA's other assets rising to 42 per cent of total holdings in 1976 from 28 per cent in 1974. (see Table 2). Sharply rising placements in longer-term U.S. government securities and purchases of U.S. corporate bonds and equities account for most of this shift -- bringing the U.S. share of SAMA's non-bank assets up to nearly two thirds. However, aid activity, both bilateral and through Saudi dominated OPEC institutions, also increased in absolute terms and as a percentage of total investments.

This shift toward longer-term investments largely reflects changes in international interest rates rather than bold innovations in investment policy. With the country's liquidity position very strong by late 1974, SAMA began moving longer term and diversifying its portfolio by acquiring new types of assets. This change is sometimes associated with the death of SAMA's conservative Governor Anwar Ali and the subsequent ascendance of bolder men such as Aba-al Khayl and Crown Prince Fahd (as assisted by advisers from Baring Brothers of London and White Weld and Company). However, yield considerations appear to have played a stronger role: the switch in emphasis from money market to capital market instruments has taken place at a time when inflation was decelerating worldwide and the interest rate spread began favoring longer-term assets. It therefore seems that the Saudi investment pattern is consistent with rational investment behavior. However, SAMA does not appear to deal actively in the market as do professional commercial participants and a number of other OPEC investment institutions. Rather it follows a conservative approach partly because it regards Saudi investments as a means of storing wealth over the longer term and partly because the Saudi government is concerned with the impact of its actions on world financial stability.

The U.S. Market

The change in asset composition and maturity structure of Saudi investments has coincided to a considerable extent with accelerating placements in the United States. This is not surprising given the size, depth and variety of the U.S. capital market. At the same time, it should be remembered that other outlets for longer term investments, such as Germany and Japan, have been limited owing to administrative restrictions and stringent investment laws. Last year, one half of total official Saudi placements come to the U.S. market, bringing the share of U.S. holding in Saudi external assets to 33 per cent. Since the entire increase was accounted for by long-term holdings, and given Saudi dominance in OPEC as a whole, the effect was to lengthen rather dramatically the maturity profile of total OPEC portfolio holdings in the U.S. (see Table 6). By end-1976 Saudi Arabia not only accounted for more than one half of OPEC's total U.S. portfolio but also took up fully three fourths of OPEC's long-term holdings (see Tables 5 and 6). Saudi corporate bond and equity purchases, which rose from negligible amounts to nearly last year have certainly played a part but the vast increase in long-term assets is attributable to Treasury bonds and notes, which jumped in 1976, and to Federal Agency securities, which rose from about over the same period. Consequently, FRBNY now holds 70 per cent of Saudi Arabia's U.S. portfolio compared with about 50 per cent at the end of 1974 (see Tables 4 and 5).

Information to date suggests that the foregoing trends in the disposition of Saudi's external assets will continue this year, with a smaller proportion of available funds going into highly liquid assets and with a general lengthening of the maturity structure of existing claims. This tendency is evident in the U.S. market where Saudi holdings of Treasury bills declined absolutely in the first half of 1977, at the same time that purchases of longer-term assets equaled last year level, measured at an annual rate (see Table 3). Overall, however, the pace of total portfolio investment in the United States has been slower than last year, and given expectations that the Saudi current account balance will remain essentially unchanged, this portends a small decrease in the U.S. share of available Saudi funds. The slowdown may be related to the recent weakness of the dollar. However, fears that the decline of the dollar in foreign exchange markets during June and July might lend to an actual reduction in Saudi dollar asset holdings have not been realized and were probably overstated. It is estimated that 85 per cent of total Saudi holdings are in dollar denominated assets so that major switching to other currencies would adversely affect the value of these already very large dollar balances. Instead, the fall in the dollar rekindled interest among Middle East oil officials in SDR oil pricing as a means of protecting and stablizing the value of oil revenues. More than two years ago OPEC members unanimously voted to price oil in SDRs but they postponed the move once the dollar began appreciating on the exchange markets. Similarly, since the dollar's very recent improvement, OPEC officials again stopped commenting on the question of SDR oil pricing.

Saudi Economic Assistance

Despite declining support for international development institutions such as the World Bank, Saudi loans to developing countries have grown steadily since 1974 to reach about 26 per cent of total external assets. LDCs have received substantial aid flows either bilaterally or through newly created multilateral organizations such as the Arab Fund for Economic and Social Development, the Islamic Development Bank and the OPEC Special Fund. Both the direction of bilateral flows, extended overwhelmingly to Arab and Moslem countries, and the creation of OPEC-dominated aid institutions, paralleling the functions of the IBRD, reflect the desire to link financial strength to foreign policy goals. Even so, Saudi political interests -- which center on promoting moderate and pro-Western forces in the Middle East and Africa to counter Soviet influence and hence safeguard the internal stability of its conservative monarchy -- have not conflicted with economic need criteria, as most Moslem aid recipients fall under the U.N.'s "Most Seriously Affected" classification.

Indications are that Saudi economic assistance will absorb a larger share of available surplus funds this year than in the past. Bilateral and multilateral lending already jumped impressively in the first half of 1977 reflecting: accelerated balance of payments support to Egypt under the auspices of the Gulf Organization for the Development of Egypt (GODE); the renewal of the Rabat subsidy payments to Arab "confrontation" states, initiated by an Arab summit resolution in 1974; and payments to the OPEC Special Fund, which unlike other OPEC institutions extends aid to LDCs regardless of political or religious considerations. Moreover, Saudi Arabia generously supported both Morocco and Mauritania in their struggle against the more radical Algerian state over the western Sahara. In addition to these factors, probable Saudi financial assistance for reconstruction in Lebanon will sustain the high level of its economic assistance throughout this year.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date February 18, 1977

To Mr. Pizer

From R. H. Mills Jr.

Subject: Getting more data on OPEC investment flows

As you know, our Division tables on the estimated disposition of the OPEC surplus have shown increasingly large unidentified investment flows. Such flows reached almost 40 per cent of the total estimated investible surplus in the first half of 1976, and were 55 per cent of that total in the second half.

For some time CIA has been putting out papers semi-annually on the size and distribution of OPEC official foreign assets. We have not made use of this information in our current reporting primarily because it is received so late; e.g., the paper on assets as of June 30, 1976, and the changes in the first half of last year, was published in February, 1977, at a time when our green book story was covering OPEC investments in the fourth quarter. The CIA data also have some holes in them for unidentified flows. But they do purport to identify much more than we do. I think it would be worthwhile to explore with CIA the possibility of their furnishing us with more up-to-date information. Treasury should also want more information.

For the first half of 1976, CIA estimates that the OPEC countries had a current account surplus of $19.9 billion and loan receipts of $3.8 billion, and they try to estimate the uses of the $23.7 billion sum of these foreign exchange receipts. Their estimate of official and private investments in the United States and the United Kingdom, including Euro-currency deposits in the U.K., is $5.9 billion compared with the $8.5 billion we currently show, and we ought to explore with them why their figures are so different. ($2.6 billion of this difference concerns the U.K.) Their figure for IMF and World Bank investments coincides with ours, but for Continental Europe and offshore banking centers they show $2.3 billion, whereas we use a figure (obtained from the Bank of England) of $1.5 billion for Euro-currency and other bank deposits in those areas plus other areas outside the U.S. and the U.K., since we have no information on any investments in those areas in forms other than bank deposits.

The remaining uses of the surplus, according to CIA, included _inter alia_ $3.6 billion of increase in receivables from the oil companies, a figure much higher than I would have estimated from the changes in monthly oil production and price figures at my disposal. Changes in official OPEC assets in Canada and Japan ($0.5 billion increase) and in Communist countries ($0.2 billion decrease) were estimated to be small, but the estimated rise in official assets in other countries not specified in the paper was substantial ($2.1 billion; I would guess this was largely loans to Arab countries, Pakistan and India). Other identified uses of OPEC foreign exchange receipts included $0.5 billion of nationalization compensation by Nigeria and Venezue , $1.5 billion of subscriptions to multilateral aid organizations, and $1.5 billion of debt repayment, mostly by Algeria, Indonesia, and Iran (the main OPEC borrowers on the Euro-credit market). We do not receive current information on any of the $9.5 billion of uses of OPEC funds described in this paragraph. This figure somewhat exceeds the $7.4 billion of unidentified flows in our latest table.

CIA also comes up with a not insignificant amount of gaps to fill. They cannot find the location of $1.6 billion of increases in official assets reported to the IMF, and in trying to reconcile identified flows with the estimated OPEC surplus they are left with positive net errors and omissions of $2.3 billion. But this $3.9 billion gap is only 16 per cent of the $23.7 billion of current account surplus and borrowing proceeds to be accounted for, a much smaller residual than we get.

cc: Managing Group, Mr. Smith, Mr. Terrell, Mr. Fleisig, Mrs. Terrie

D. PROBLEMS IN FEDERAL AGENCY MONITORING OF IRANIAN ASSETS AND INVESTMENTS IN THE UNITED STATES PRIOR TO AND AFTER THE ASSET FREEZE (A CASE STUDY)

THE UNDER SECRETARY OF THE TREASURY
FOR MONETARY AFFAIRS
WASHINGTON, D.C. 20220

RECEIVED
FEB 29 1980
Benjamin S. Rosenthal, M.C.

February 28, 1980

Dear Ben:

I was pleased that we could find the time to lunch together last Wednesday and have the opportunity to discuss at length a variety of subjects, including questions raised in your letter to me of January 21, 1980.

I think it would be useful for me to reiterate in this letter a number of the points concerning Iranian assets data that I made at our discussion Wednesday.

Most of the confusion concerning the amount of Iranian assets which were blocked on November 14 arises from a misunderstanding of the nature of the data which were being provided publicly. At the time of the announcement by the President the morning of November 14, a rough estimate was provided the press on the amount of Iranian assets which may have been caught in the freeze. This rough estimate was based on the latest data available from our regular reporting systems. These systems provide information on the positions of U.S. banks and non-banks as of the end of each month and the end of each quarter respectively. They do not provide daily figures.

Immediately after the announcement of the blocking action Treasury and Federal Reserve Board officials began to survey U.S. banks to determine the precise amount of their claims on and liabilities to the Iranian public sector that were outstanding as of close-of-business November 13. As these reports came in, we provided the public at several points with limited information about the latest aggregated figures on the position on November 13.

After the initial telephone survey was completed, Treasury officials arranged with the Federal Reserve Board to collect more detailed data from banks on their positions vis-a-vis Iran. This process in fact is still going on. Current total claims on and liabilities to Iranian government entities change constantly for a variety of reasons:

-- some fresh funds have been flowing into blocked accounts;

-- some payments out of these accounts have been licensed;

-- some banks have set-off their claims against their liabilities in their overseas branches.

Still there are changes as individual banks revise their submissions to take account of the disposition of transactions in process at the time of freezing and clarify the distinction between private Iranian accounts not to be blocked and those of official entities.

The data available to us before the freeze were all we needed to enable us to decide on the desirability of instituting the freeze. We would not have expected to know in advance the exact amount which would be caught by our blocking action. On November 13, we knew from our formal reporting system the following categories of information about Iranian assets held in the United States and Iranian deposits in foreign branches of U.S. banks.

Iranian Holdings of:	As of:
U.S.G. Securities	September
Deposits in Banks in the U.S.	September
Deposits in Foreign Branches	June
Private U.S. Stocks and Bonds	September
Non-Bank Liabilities	June
Direct Investment	June

In addition, information on the value of gold and securities held at the Federal Reserve is available every day. Similarly the deposit liabilities of U.S.G. agencies are available on one or two days notice.

The reporting systems were adequate to meet initial requirements of the Iranian crisis. Our reporting systems enabled us to determine the existence of substantial U.S. liabilities to Iran and to conclude that blocking action would be an effective response to the Iranian threat to default on its obligations.

Naturally, it is to be expected that the positions of U.S. residents vis-a-vis Iran on November 13 differed from those indicated by the formal reporting systems of the most recent previous reporting dates. A significant amount of receipts and payments flow into and out of American banks each day. These differences, however, are not so large to prevent us from making the appropriate policy decisions. Daily collection of capital movement data would be a costly burden and is not necessary to enable us to make appropriate policy decisions.

I will be leaving Treasury on February 28, and expect to undertake my new responsibilities at the Federal Reserve Bank of New York on April 1. I hope you will have time before long to visit with me in my new office.

Sincerely,

Tony

Anthony M. Solomon

The Honorable
Benjamin S. Rosenthal, Chairman
Subcommittee on Commerce, Consumer,
and Monetary Affairs
Committee on Government Operations
House of Representatives
Washington, D.C. 20515

Washington Post, 11/20/79

U.S. Now Says Iranian Assets Top $8 Billion

By Hobart Rowen
Washington Post Staff Writer

Carter administration officials yesterday again boosted—this time to "more than $8 billion"—their estimate of the value of Iranian assets blocked by last week's presidential order, and indicated the total could rise higher when a full tally is in.

Meanwhile the U.S. dollar again declined on continued doubts that Iran would maintain its practice of pricing oil in dollars. Iranian officials also hinted that actual oil production might be reduced.

Deputy Treasury Secretary Robert Carswell said at a press conference that the new estimate of frozen assets—first put at $5 billion, then revised last Friday to $6 billion—now includes the following:

- $1.8 billion held at the Federal Reserve Bank of New York, including $1.2 billion in Treasury securities, and about $600 million in gold valued at current market prices.
- $400 million on deposit at the U.S. Treasury against U.S. defense equipment orders.
- More than $1 billion in deposits in domestic U.S. commercial banks.
- More than $500 million on deposit in domestic nonbank U.S. companies.
- $4 billion on deposit in foreign branches or subsidiaries of U.S. banks.

That adds up to $7.7 billion, with

See ASSETS, D8, Col. 1

Iranian Assets Estimated At More Than $8 Billion

ASSETS, From D7

the estimate moved up to "more than $8 billion" to cover the bank and nonbank deposits here that haven't been counted.

Carswell said the Treasury is getting reports from 160 banks, and the assets total could be even more when the count is completed. In addition, something "less than $300 million" in foreign currencies held by Iran in American branches abroad was unblocked by the Treasury yesterday.

According to an official interpretation of the freeze order, Eurodollar transactions that must clear through New York for payment to Iran aren't blocked by the order.

And government examiners said they are going through the records of the Iranian Bank Melli in New York, where most accounts to support Iranian students here appear to be held. The intention is to license payments out of those accounts for a limited time, Carswell said.

The dollar continued to be affected by fears that Iran and perhaps other oil producers would reject dollars as payment for oil, forcing oil-consuming countries to dump dollars on world markets to get the kinds of paper currency oil producers would take.

Abul Hassan Bani Sadr, Iran's acting foreign minister, repeated last week's threat by the Iranian finance minister to replace the dollar with a basket of other currencies as a basis for pricing Iranian oil.

Bani Sadr called on other cartel nations to do the same thing, warning that their petrodollar deposits in American banks are "verbal and unreal bank accounts" as shown by the U.S. order blocking Iranian assets.

"We must achieve self-sufficiency in order to be prepared to completely drop dealings and cut off dealings with America," Bani Sadr said, according to a statement attributed by the Associated Press to a Tehran radio broadcast.

Meanwhile, the official Iranian News Agency quoted Iran's oil minister, Al Akbar Moinfar, as saying that Iran "had not and would not" cut its oil production. Moinfar also had contradicted the finance minister's prediction of last week that Iran would move to a currency basket for pricing oil.

But although Moinfar gave some assurance on production, he added an element of uncertainty by saying that "on the other hand," the cut-off of oil to the U.S. hadn't reduced Iran's total revenues because of record prices it is getting in the spot market to which oil is being diverted.

According to the Iranian news agency, Moinfar said Iran had no trouble in finding customers for 75,000 barrels a day at $45 per barrel in the spot market. Until Carter's order cut off imports last week, Iran was selling this country about 700,000 barrels daily.

Gold closed unchanged in London yesterday at $390.50 an ounce as traders were hesitant to make major commitments in view of all the uncertainty, gold dealers said.

In Frankfurt, the dollar was down to 1.7605 marks from 1.7740 Friday. There were similar declines against the Swiss and French francs, Dutch guilder and Italian lira. The pound was up 3 cents in London to $2.1870, reacting positively to a new minimum lending rate of 17 percent.

In Tokyo, where the dollar has been rising steadily for weeks, it was down fractionally to 246.35 yen. The Bank of Japan reportedly has been intervening to prop up the yen, weakening because of inflation and the tense oil situation.

D.C. Area Securities

BANKS AND INSURANCE	Vol.	Bid	Ask
1st Am Bk Md	*	10	11
Cit Bk Md	*	42½	45½
Col Am	0	9½	10¼
Comm Bk Colo	0	7½	8½
Madison NB	*	35	37
NS&T	*	62	68
MISCELLANEOUS			
Al Cap	200	10¼	11
Al Res	1,975	9¼	10
Bell	500	6½	8
Biosphrcs	4,900	7	8
Cap Recl	*	½	1½
Como Data	1,180	5¾	6¾
Fir Fin Va	150	21¾	23[illegible]
Freeman	350	4½	5¼
Gelco	1,316	9¾	10½
Gelco Pf	1,288	10¾	11¾
Ginn	731	10	10½
Gt Ser S&L	100	6¼	6¾
Hamb Ham	100	5	6½
Hechinger's	876	13⅞	14⅜
Holobeam	0	2⅝	3⅛
MCD	0	2½	3¼
Microdyne	8,680	21	21¾
MIW SBI	1,400	2⅝	2⅞
MIW Wt	0	1/32	3/32

	Vol.	Bid	Ask
Neotec	*	3/16	1 3/16
NVDH	*	2¾	8¾
Pubco	45,900	1¾	2½
Quanta Sys	*	1½	2½
Rad Sys	0	8½	9¼
Riv Re	*	6	7
Schwitz	0	2	3/
Sci Time Shar	300	7¼	8
Solon	0	6⅞	7⅛
Sys Gen	0	3½	4¼
Un Con	0	3¾	4¾
Un Fin Va	363	6½	7½
US Hlth & Rec	0	1	1¾
V&E	*	8¾	9½
Waxie Max	*	2½	[illegible]
Wil In	[illegible]	[illegible]	[illegible]
AUTHORITY BONDS			
Md B&T		85½	88½
Ches BB&T		70	71
Va Tl 4		69	72
Eliz Riv		100½	101
Metro 7.35B		77½	78½
Metro 7.75C		81¾	82¾
Metro 8.15D		85¾	86¾

*—Volume statistics are available only for NASDAQ listed companies

London Stocks

LONDON (AP)—The Financial Times daily index of 30 London industrial stocks yesterday was 411.3 up 4.6.

The Financial Times Daily index of 500 London stock actuaries was 244.88 up 2.62.

IRANIAN ASSET CONTROLS

NOTE: EXCERPTS FROM:

HEARING

BEFORE THE

SUBCOMMITTEES ON EUROPE AND THE MIDDLE EAST

AND ON

INTERNATIONAL ECONOMIC POLICY AND TRADE

OF THE

COMMITTEE ON FOREIGN AFFAIRS
HOUSE OF REPRESENTATIVES

NINETY-SIXTH CONGRESS

SECOND SESSION

MAY 8, 1980

Printed for the use of the Committee on Foreign Affairs

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other property to any person in Iran. Was that order issued solely under the authority of IEEPA or was the authority drawn from the Export Administration Act?

Mr. DAVIS. The authority for that was the IEEPA in terms of the prohibition on remittances to Iran, to people in Iran. That was premised on the IEEPA.

Mr. BINGHAM. I think I saw some mention in the media that the Export Administration Act was involved there but my own view was that it did not contain that kind of authority and therefore I think was probably correctly based on the IEEPA.

Mr. DAVIS. It is based on the IEEPA. Various Executive orders contain various prohibitions, cite a series of statutes, but the authority to prohibit the remittances is IEEPA.

Mr. BINGHAM. Before yielding to my colleagues, I might say that we have received some requests from Members of Congress to testify before these subcommittees on the issues raised by various problems involving control of Iranian assets and we will schedule a hearing for that purpose in the near future.

CENSUS OF FROZEN IRANIAN ASSETS

Mr. Rosenthal.

Mr. ROSENTHAL. Thank you, Mr. Chairman.

Mr. Davis, what is the total amount of the funds that were blocked?

Mr. DAVIS. I think at this point, as you know, we are conducting a census to try and get precise numbers. It is in excess of $8 billion worldwide. When I say worldwide, I mean in the possession of institutions or individuals in the United States or U.S. institutions abroad.

Mr. ROSENTHAL. Can you just give us more of a breakdown of where the $8 billion is? Is it mostly in banks here? In banks overseas? Eight billion dollars in Treasury notes? How do you breakdown $8 billion?

Mr. DAVIS. Well, Mr. Rosenthal, as I say, we will be able to provide more precise information after the census is completed. Certainly, a substantial portion is in the Federal Reserve Bank; another substantial portion is in U.S. banks.

Mr. ROSENTHAL. How long have you been working on the census?

Mr. DAVIS. The census was announced on April 7; the regulations requiring reports were filed that afternoon. The reports are due back on May 15. Those reports, which are required of all persons subject to the jurisdiction of the United States who are holding assets which were blocked on or after November 14, must be reported under the terms of those regulations. Once we receive that information on or by May 15, then, of course, it must be computerized, analyzed, and developed.

Mr. ROSENTHAL. Without the informatiou from the census, Treasury had no other way of knowing where the particular assets of any foreign country are?

Mr. DAVIS. I think you are familiar, Mr. Rosenthal, as a result other meetings and conversations, that there are various ways that we have tried to conduct surveys, both prefreezing and postfreezing. I am personally not an expert with all the reporting systems that exist in the Treasury Department. I know you have had an interest in those reports and have had hearings and discussions about those.

I do know that, as we said, we have estimated that the amount is in excess of $8 billion.

Mr. ROSENTHAL. It is important for the Congress to know, as a matter of public policy, whether those funds are under direct U.S. Government control; that is, Treasury notes, or whether they are under the banks, and what the banks control. There are some political implications that flow from the names of the banks that they may be under the control of.

Mr. DAVIS. I understand that, Mr. Rosenthal. As I said, we are conducting a census.

Mr. ROSENTHAL. I was surprised at the complexity of the census. Can you tell us or do you know where the $8 billion is?

Mr. DAVIS. Well, I think it would be unfair for me to say that we have not tried to conduct, and conducted, surveys to try and identify, to the extent we can, principal locations of assets.

LOCATION OF ASSETS

Mr. ROSENTHAL. After the census is concluded, will you know specifically which banks have which money?

Mr. DAVIS. Presumably we will have specific information not only about banks but other institutions as well.

Mr. ROSENTHAL. Will you know whether the funds are held physically in the United States or abroad under the supervision and control of the U.S. banks?

Mr. DAVIS. We will have that, yes.

Mr. ROSENTHAL. But, as of now, the Treasury does not know that?

Mr. DAVIS. That is not what I said, Mr. Rosenthal. I said since November 14 we have conducted various surveys to collect as much information as possible. This survey is the first formal survey. When I say formal, under the compulsion of law, so this will give us the most complete picture. Our estimates of in excess of $8 billion worldwide are based on that other survey.

Mr. ROSENTHAL. For example, I am told that $1.3 billion in marketable securities are held by the Federal Reserve bank in New York. Do you know that?

Mr. DAVIS. I don't have it at my fingertips right now. There are assets that are at the Federal Reserve bank in New York.

Mr. ROSENTHAL. Are there legal distinctions in terms of whatever follows from the blocking as to whether funds can be attached or not? In other words, that is, private custody, a bank compared to, for example, a Federal Reserve bank?

Mr. DAVIS. I would not want to give a legal opinion but one legal situation is related to whether the assets of the Central Bank should be treated differently from the assets of other institutions. That is certainly one of the legal issues that does exist in the New York litigation. We are talking about Central Bank assets.

Mr. ROSENTHAL. Where do you get the figure of $8 billion from?

Mr. DAVIS. As I said, since November 14 we have conducted informal surveys to try and get the best information possible.

Mr. ROSENTHAL. But I can't figure out why it takes so long, 6 months. It seems to me you should be able to get it in a week.

Mr. DAVIS. We have conducted surveys, we do have information. What we are doing is going out for the first time with a mandatory report which will give us the kind of breakdown we want, not only of banking institutions but of any other institutions or individuals that are holding Iranian assets. We talk about blocked assets. We are not talking about only banking and bank accounts, we are talking about other obligations which may run in favor of Iran.

Mr. ROSENTHAL. What was the date the funds were blocked?

Mr. DAVIS. They were blocked November 14.

RESULTS OF INFORMAL REPORTING SYSTEM

Mr. ROSENTHAL. Did the Secretary of the Treasury send telexes finding out how much the funds were and where they were?

Mr. DAVIS. Not telegrams sent out that morning. There was put into place——

Mr. ROSENTHAL. Did you send a telegram that morning?

Mr. DAVIS. I am not aware we sent the telegram that morning. There was very quickly put into place an informal reporting system through the Fed, through others, to try to get maximum information, and as I say——

Mr. ROSENTHAL. How long has that taken?

Mr. DAVIS. That information is the source of the "in excess of $8 billion" figure which was released sometime toward the end of November and, as I say, I believe it was discussed with you at that time.

Mr. ROSENTHAL. You had the $8 billion figure at the end of November and you still don't know where the money is?

Mr. DAVIS. I didn't say that. We do know where the money is. We did those informal surveys. We are now, however, doing a formal census.

Mr. ROSENTHAL. Why do you have to go to a formal census after the informal survey?

Mr. DAVIS. I think one wants to make sure in terms of the form of reporting that you get it as required. Two, you want to uncover sources which you may not have reached through our informal surveys. That goes to the——

Mr. ROSENTHAL. Did you ever ask the Chase Manhattan Bank how much they had?

Mr. DAVIS. As I said, we have gone to them through the Federal Reserve.

Mr. ROSENTHAL. How much does the Chase Manhattan Bank have?

Mr. DAVIS. I do not have that information and I am certainly not prepared at this point to discuss what individual institutions have submitted. There has been a lot of discussion with you and with others on the ability to release these figures.

Mr. ROSENTHAL. Was $8 billion, the figure that you reached after the informal survey, to become something more or less after you have the formal census?

Mr. Davis. As I said, we believe it is in excess of $8 billion.
Mr. Rosenthal. Would it be 10?
Mr. Davis. That is possible, but I don't really want to speculate.
Mr. Rosenthal. As a matter of curiosity, how many sources do you have to inquire from? How many people or institutions have you sent a census to?
Mr. Davis. Well, the census was distributed in 10,000 or 20,000, 30,000 copies. It does not mean they will get that many copies. It was sent through the Federal Reserve System to every bank.
Mr. Rosenthal. There is only one Federal Bank.
Mr. Davis. Yes, You are not only sending it to the Fed to report; they are sending it to them to distribute to all the member banks and the banks have those forms available for the banking community. We also sent forms to anybody who had contacted us in any correspondence or any others we might have had business with or possibly hold some Iranian assets.
Mr. Rosenthal. But the principal Iranian assets are those held by the U.S. Government and by banks. You are not worried about a department store holding some Iranian money, are you?
Mr. Davis. No; but there may be some other corporations that may be substantial.
Mr. Rosenthal. Who else would hold substantial amounts other than banks or the Federal Reserve?
Mr. Davis. There might be people who had purchased large quantities of, for example, oil from Iranian companies whose debts and obligations could be substantial.
Mr. Rosenthal. That is what you would have frozen?
Mr. Davis. Absolutely.
Mr. Rosenthal. The debt itself?
Mr. Davis. Absolutely.
Mr. Rosenthal. But the debt is not something in hand, is it?
Mr. Davis. But it is an obligation that is owed to Iran and that is frozen.

PRECISE AMOUNTS AND LOCATIONS OF FROZEN ASSETS

Mr. Rosenthal. How much in dollars, investments, and securities did you freeze?
Mr. Davis. Well, as I think I have said, Mr. Chairman and Mr. Rosenthal, we estimated in excess of $8 billion. I might say we are in a very delicate area and I would like to explain why, and that is in terms of releasing these numbers publicly at a public hearing we are not only telling you but we are telling people who we may some day be sitting across the negotiating table from.
Mr. Rosehthal. The Iranians want to know where the money is.
Mr. Davis. I would suggest, Mr. Rosenthal, that based on the reading of the public comments of the Iranians it is not necessarily clear that they know precisely what amounts are where and I am not sure we should provide assistance.
Mr. Rosenthal. We don't want to tell?
Mr. Davis. I don't think we do.
Mr. Rosenthal. I would like to know why. They know there is $8 billion so that is what they can shoot at, right?

Mr. DAVIS. We have said there is in excess of $8 billion.

Mr. ROSENTHAL. $8 billion. So if we told them what bank it is, what advantage would that be to them?

Mr. DAVIS. Well, we are also talking about the amounts. What I am saying is in terms of the amounts——

Mr. ROSENTHAL. If it were $15 billion, that would whet their appetite more?

Mr. DAVIS. If you are negotiating with somebody, Mr. Rosenthal, I think the more we know that the other side does not in any negotiation helps.

Mr. ROSENTHAL. You are not telling us you don't have the information, you don't want to pass it through?

Mr. DAVIS. We have conducted informal surveys, in excess of $8 billion has been identified. We are reluctant to discuss in any further detail. We are conducting a census to get, I think, a much more complete picture which will tap all the sources.

Mr. BINGHAM. The time of the gentleman has expired.

Mr. ROSENTHAL. I think their time has expired.

Mr. LAGOMARSINO. I suspect that you do know but you don't want to say.

Mr. DAVIS. I believe it was sometime in November, late November or early December, the fact that we had in excess of $8 billion. We do not want to discuss in detail the precise amounts in further detail.

Mr. LAGOMARSINO. As I recall on November 14, when the blocking was announced, it was estimated at that time there was $8 billion.

Mr. DAVIS. I think the estimate at that time was less.

Mr. LAGOMARSINO. It was less?

Mr. DAVIS. I think it was a figure of $4 billion.

Mr. LAGOMARSINO. We have to go back and look. I thought it was $4 billion in this country and perhaps $4 billion in other countries. Anyway, whatever the record shows it is or was.

Obviously at some point we are going to have to discuss this in closed session but on the record I don't see why we should be so concerned if the Iranians know how much of their money we have blocked. It would appear to me by the time the banks and whoever make their claims against those assets and we make our claims, and I personally think they should include substantial damages for every hostage, and I submit they should cover a substantial portion, if not all, of the cost of maintaining our fleet in the Indian Ocean. I don't think there is going to be any money left over, so what do we care?

Mr. DAVIS. We are talking about how we get from here to there in terms of what is included in dealing with claims. There is a lot of speculation as to how we would get from here to there, and sometimes you get there and it is through negotiation.

Mr. LAGOMARSINO. Now on page 2, the chairman referred to part of what I was going to ask you but I would like to just clarify it for my own purposes here. The IEEPA was completely substituted for the Trading with the Enemy Act, is that correct?

Mr. DAVIS. With respect to nonwartime national emergencies and with the exemption of savings provisions for then-existing emergencies.

NOTE: EXCERPTS FROM:

[COMMITTEE PRINT 97-5]

IRAN: THE FINANCIAL ASPECTS OF THE HOSTAGE SETTLEMENT AGREEMENT

COMMITTEE ON
BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

97th Congress, First Session

JULY 1981

Printed for the use of the
Committee on Banking, Finance and Urban Affairs

This report has not been officially adopted by the Committee on Banking, Finance and Urban Affairs and may not therefore necessarily reflect the views of its members

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justifying the use of IEEPA were examined again. Foreign Minister Bani-Sadr's threat to withdraw Iranian assets became a critically important justification for the freeze because of the sensitivities of several U.S. friends and allies, particularly Saudi Arabia and Kuwait. For the same reasons as existed in February, however, the Bani-Sadr threat did not present a plausible economic danger to the U.S., based on the consistent Treasury position to that effect. Clearly, the main justification for the freeze (and an entirely legitimate one) was political—the need by the Administration to respond forcefully to the taking of the hostages and the support for the taking offered by Ayatollah Khomeini. Indeed, indications are that a consensus to proceed with a freeze had been reached well before Bani-Sadr's statement and Treasury Secretary Miller's early morning call to President Carter recommending a freeze.

In light of the expansive interpretations given to the economic emergency authority under IEEPA in some government quarters during the Iran crisis, it would now be appropriate for the Congress to provide future administrations with clearer guidance as to those circumstances which should constitute an economic emergency under IEEPA.

(5) There was minimal consultation with Congress at certain critical junctures in the hostage crisis, characterized by the early morning notice to House leadership and Committee chairmen that the President was about to institute a freeze. While the timing and depth of that consultation may be consistent with existing law, consideration should be given to clarifying the scope of Congress' role in the consultative process.

(6) The extensive telephone contacts by Department of Treasury and Federal Reserve Bank officials the weekend prior to the official announcement of an assets freeze provided an opportunity for experienced bank officials to deduce that an assets freeze was to take place in the not too distant future. If a freeze is to remain confidential until the point of a Presidential declaration so that banks could not act to thwart the freeze, the data collection by U.S. Governmental agencies pertaining to foreign deposits in U.S. financial institutions and other relevant commercial information must be kept more up-to-date than apparently is possible under the existing data collection process. Also the entire reporting requirements on foreign deposits or equity investments in the United States should be reviewed.

(7) The role of Chase Manhattan Bank and its Chief Executive Officer David Rockefeller in influencing the financial aspects of the hostage crisis is much overstated. The study indicates that Mr. Rockefeller, who was personally acquainted with the Shah, was not an intimate associate to the degree that is often assumed. No evidence has been found to verify that Chase Manhattan Bank was the depository for the alleged billions of dollars which the Shah had purportedly transferred from Iran either directly or indirectly through other sources such as the Pahlavi Foundation. From all indications, Chase Manhattan Bank and its financial posture were not subjects discussed during any of the talks pertaining to the admission of the Shah to the United States. There is no evidence that either Chase or Rockefeller attempted to persuade the U.S. Government to impose a freeze of Iranian assets, nor did they have control over the timing of the freeze or any advance knowledge of the freeze other than by means of inferences they may have drawn from Government inquiries on the status of Iran's assets

7. Authorizing certain payments under letters of credit drawn on U.S. banks. Companies involved in standby letters of credit were allowed to open blocked accounts on their books when Iran demanded payment (Dec. 3, Dec. 19, Jan. 9).

8. Authorizing transfer of funds from demand deposits to interest-bearing status at an Iranian depositor's instruction. Unlicensed extensions of new or renewed credit to Iran after Nov. 14 were prohibited (Dec. 28).

The flow of regulations tapered off during the period of January–April 1980 until President Carter imposed new economic sanctions on Iran. On April 7, citing the earlier freeze and the continuing economic threat posed by Iran's lack of recognition of the World Court and United Nations actions, President Carter issued Executive Order 12205 which included the following:

1. The blocking of all commerce between the U.S. and Iranian entities or persons (excluding foreign subsidiaries of U.S. companies), except for food, medicine and other medical supplies and clothing donations, and transportation connected with that commerce;

2. Prohibitions on banks making new loans to Iran, letting Iran significantly increase its non-dollar bank deposits, and on banks "failing to act in a businesslike manner" (e.g., failing to employ the usual remedies with respect to Iran's failure to make timely loan payments);

3. Barring U.S. entities from entering new service contracts for industrial projects in Iran.

On April 17, President Carter took further actions, citing the Soviet occupation of Afghanistan in addition to the reasons announced on April 7. Executive Order 12211 added these new sanctions:

1. Prohibited direct or indirect imports of goods or services from Iran.

2. Forbade transactions with foreigners regarding travel to Iran.

3. Barred payments by or on behalf of Americans in Iran of expenses for transactions in Iran.

4. Prohibited any payments or other asset transfers to Iran, except for family remittances. (News gathering activities were exempted from these first four sanctions).

5. Revoked all licenses for transactions with Iran Air, National Iranian Oil Company and National Iranian Gas Company.

6. Undelivered defense articles, delivery on which was suspended in November 1979, were to be converted to U.S. government use or transferred to other buyers.

The Treasury Department issued a series of regulations in April and May to carry out these new Executive Orders. Many of these new regulations simply paraphrased the terms of the Executive Orders.

On April 9, 1980, Treasury published a very significant requirement, commonly known as the census, which mandated the filing of reports by American entities and persons on Iranian assets and claims. Responses were required by May 15, 1980. This census was intended to become a comprehensive source of the exact financial relationship each U.S. bank had with Iran. Unfortunately, the census never yielded the type of accurate data that would reflect the actual position of each financial institution precisely enough for use during the final detailed settlement negotiations. The numbers constantly fluctuated, and though the variations usually involved relatively small sums, they made the census unreliable. In addition, the office in Treasury which updated the numbers was not the office which originally gathered the information.

In December 1980, when negotiations with the Iranians appeared to be approaching resolution, the U.S. banks involved in syndicated loans developed their own set of numbers with the help of Peat, Marwick, Mitchell and Co. Similarly, the government, with cooperation from the Federal Reserve Bank of New York, again surveyed the banks seeking a more accurate listing of the Iranian deposits and loans.

We cannot assess whether the inadequacies of the census are the responsibility of the Department of Treasury, which compiled the census, or of the banks responding to the census. However, we can state that there were serious problems with the methods used by the Department of Treasury to gather precise statistical information throughout the course of the freeze.

A General Accounting Office report prepared during the freeze and issued on November 14, 1980 criticized the efficiency of Treasury's Office of Foreign Assets Control. GAO criticized the Treasury Department's inability to maintain control over blocked assets in carrying out a number of freezes involving countries other than Iran, as well as the most recent effort in Iran. The committee staff has found that many of the reforms suggested by GAO had been previously proposed internally within the FAC office and now have been implemented under the office's new Director, Dennis O'Connell. Given its modest staff resources, the office worked under extremely difficult circumstances in gathering the complicated statistics and administering the licensing program under the freeze.

In addition to the difficulties encountered in gathering and reporting statistical data for purposes of the census, many of the compliance problems faced by banks after the imposition of the freeze were resolved either through general licenses issued in the Treasury regulations, or through specific licenses granted to individual banks. One of the first of the general licenses authorized by Treasury involved set-offs, which are actions taken by banks to reduce their deposit liability to Iran by the amount of the Iranian assets they held. Treasury authorized set-offs against foreign deposits on November 16, 1979, a decision that resolved early questions about whether set-offs would be allowed, particularly against unmatured debt. Within a few days after the freeze, Treasury regulations answered other questions. The issues dealt with in these regulations included whether non-dollar deposits overseas would be subject to the freeze; whether Iran could pay its obligations out of unblocked funds; and whether deposits could be transferred between foreign and domestic accounts.

One major question that was never resolved by final regulation was whether banks were obligated to put Iranian funds in interest-bearing accounts. Treasury's Foreign Funds Control Regulations, which governed previous blocking actions but did not apply to the Iranian freeze, had been revised in March 1979 to require that blocked

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C O N F I D E N T I A L STATE 025573

E.O. 12065 GDS 1/30/85 (JOHNSON, MARK)

TAGS: EFIN, IR

SUBJECT: TREASURY AND FEDERAL RESERVE POLICY ON IRANIAN ACCOUNTS

REF: TEHRAN 1521

TREASURY TELECOMMUNICATIONS
JAN 30 10 47 PM '79
TELECOMMUNICATIONS BRANCH RM. 2049-C MT BLDG.

1. THE FEDERAL RESERVE HAS NO AUTHORITY TO INITIATE BLOCKAGE OF ANY COMMERCIAL BANKING OR FEDERAL RESERVE ACCOUNTS. ONLY IF THE PRESIDENT DECLARED A NATIONAL EMERGENCY RELATING TO IRAN COULD THE TREASURY SECRETARY BLOCK IRANIAN ACCOUNTS, AND THERE IS NO RPT NO PLAN TO ISSUE SUCH A DECLARATION.

2. THERE MAY BE SOME CONFUSION BECAUSE THE FEDERAL RESERVE BANK EXAMINERS INITIATED AN INFORMAL SURVEY ON JANUARY 26

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PAGE 02 STATE 025573

AMONG SOME MEMBER BANKS TO DETERMINE LEVELS OF EXPOSURE IN IRAN IN ORDER TO EVALUATE IMPACT ON INDIVIDUAL BANKS OF POSSIBLE DELAYS IN PAYMENT. NEW YORK FED IS INFORMING BANKS INCLUDED IN SURVEY THAT THE QUESTIONS ARE NOT POSED WITH THE THOUGHT OF LATER BLOCKING ACCOUNTS BUT SIMPLY TO ASCERTAIN THE NATURE OF EXPOSURE IN THE EVENT OF LONG DELAYS IN PAYMENTS.

3. ANOTHER POSSIBLE SOURCE OF CONFUSION MAY RESULT FROM ATTEMPTED ATTACHMENT BY A PRIVATE PARTY OF AN ACCOUNT WITH CHASE WHICH IS HELD IN NAME OF "IRANIANS' BANK" RPT "IRANIANS' BANK." AS THE EMBASSY IS AWARE, THE USG HAS NO CONTROL OVER SUCH ACTIONS BY PRIVATE PARTIES.

4. NY FED PRESIDENT VOLCKER HAS CALLED FINANCE MINISTER PIRASTEH TO CONVEY THE ABOVE. HE ADDED THAT IT IS IMPORTANT FOR THE IRANIANS TO MAINTAIN CLEAR AUTHORITY FOR ACTIONS BY THE CENTRAL BANK IN ORDER TO FACILITATE TRANSACTIONS AND MAINTAIN CONFIDENCE THAT THE IRANIAN FINANCIAL SYSTEM REMAINS OPEN.

5. EMBASSY SHOULD REPEAT THE ABOVE TO MINISTER PIRASTEH AT THE EARLIEST OPPORTUNITY.

6. NEITHER WASHINGTON AGENCIES NOR THE FED ARE PLANNING A PRESS RELEASE BECAUSE IT WOULD PROBABLY STIR ADDITIONAL CONCERN HERE. A Q AND A HAS BEEN PREPARED AND WILL BE CABLED SEPTEL. VANCE

DEPARTMENT OF STATE

Washington, D.C. 20520

J.C. Chnn

February 2, 1979

CONFIDENTIAL
MEMORANDUM

TO: EB/ORF - Mr. Bosworth

FROM: EB/ORF/FSE -

SUBJECT: Inventory of Iranian Assets in the U.S.

There is very little information available about Iranian-owned assets in the U.S., since most transactions may be made without encountering any reporting requirement. Based upon a telephone conversation with a rough figure of was developed as an estimate of the value of all Iranian assets in the U.S. The CIA estimated official financial holdings as of mid-1978 at comprised of in gold, in bank deposits, and in U.S. Government securities. As you know, last Thursday the New York Fed was instructed to sell of Iranian-held Treasury bills, and the Treasury now estimates Iranian official financial holdings in the U.S. at

Non-Financial Assets

No one has any firm estimate of the size, distribution, or composition of Iranian private real assets in the United States. Iranian private and semi-official assets in the U.S. are probably measured in Iranians have generally preferred real estate over corporate or government securities. Real estate provides the Iranians with maximum anonimity and does not require business experience or contacts to maintain the value of their investment.

The Department of Commerce has received reports of Iranians buying in the last few years several hundred expensive homes in southern California. has a dollar office building in has bought a dollar housing complex in All this suggests that Iranians have been moving some of their wealth into

U.S. real estate, but there is no good estimate of the amount of dollars involved.

Attachment of Assets

The Foreign Sovereign Immunities Act of 1976 provides complete immunity from attachment and from execution for GOI Central Bank holdings in the U.S., as well as for property intended for use in connection with a military activity and under the control of a military authority or defense agency. Property of other Iranian government agencies and instrumentalities, including assets of corporations in which the GOI has a majority ownership interest, is also protected in the U.S., although with certain limited exceptions. The most relevant exceptions are for property which "is or was used for the commercial activity upon which the claim is based," and for other property such corporations in legal cases arising out of commercial activity carried out in whole or in part in the United States or which "causes a direct effect" in the United States. In these cases, the foreign government property can be attached in execution of a judgment, but is immune from attachment in preliminary stages of proceedings, "until a reasonable period of time has elapsed following entry of judgment." Only if the foreign state has "explicitly waived" its immunity can such property be attached prior to the entry of judgment and, even then, it can be attached only for purposes of securing satisfaction of an ultimate judgment, not to obtain jurisdiction. That means an Iranian government organization can't be brought into a U.S. Court simply because it has assets in the U.S.

The International Emergency Economic Powers Act of 1977 confers upon the President the power to block foreign assets in the U.S., similar to some of the powers provided under the Trading with the Enemy Act. Implementation of these powers requires a Presidential determination and consultation with the Congress, and would only be undertaken under an extreme emergency or in face of the most dire provocation.

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Iranian Direct Investment in U.S.

– no separate data available (disclosure requirement)

end 1977 all OPEC $157 million

Commerce estimates Iran at under $10 million

mainly in financial and some real estate

1974 benchmark survey identified 14
Iranian respondents.

Iranian controlled assets in U.S. relatively ~~[illegible]~~

multiple of $10 million or major investments in

banks.

Direct Investment U.S. – Iran.

~~OA 1977~~

~~OB.~~ V.S. Direct Investment Position Abroad, yearend 1977
(millions of dollars)

~~Q~~ All industries	Petroleum	other
-194	-411	+217

(negative due to U.S. company liabilities to Iranian oil affiliates for oil purchased but not yet paid for)

end 1966 benchmark survey (latest available)

V.S. majority owned foreign affiliates in Iran had assets of $410 million for all industries (of which $365 in petroleum)

86-722 0447

United States Senate

COMMITTEE ON FOREIGN RELATIONS

WASHINGTON, D.C. 20510

December 5, 1979

The Honorable Anthony M. Solomon
Under Secretary for Monetary Affairs
Department of the Treasury
Washington, D.C. 20220

Dear Mr. Solomon:

As you recall, during the November 14, 1979 Executive Session of the Senate Committee on Foreign Relations, a number of questions were asked by members which at the time you were unable to answer. It was agreed that you would supply those answers for the record at a later date. I understand that there have been discussions between our staffs on one of the major questions that Committee members had with respect to the level of Iranian assets in American financial institutions. I appreciate the cooperation you have shown on this matter.

After a review of the transcript, we note that the following are questions which we would like you to answer to complete the record:

1. Were any Iranian assets transferred from U.S. institutions during the time which elapsed between the Iranian announcement to withdraw these funds and the President's decision to freeze all assets?

2. What is the current level of American private and public financial claims on Iran?

3. What is currently the level of American assets in Iran?

4. What do you estimate to be the level of assets held by the Pahlavi Foundation? by the Shah of Iran?

I would appreciate expeditious action on this request so that members of the Committee may be kept informed in a timely fashion on events as they pertain to the current Iranian situation.

Sincerely,

Frank Church
Chairman

THE UNDER SECRETARY OF THE TREASURY
FOR MONETARY AFFAIRS
WASHINGTON, D.C. 20220

DEC 17 1979

Dear Mr. Chairman:

I am pleased to supply the information on Iran which you have requested in your letter of December 5.

Because of the delicate situation in Iran the data on U.S. claims on Iran are provided on a confidential basis. I would also emphasize that these data are subject to continuing revision as more complete information becomes available and as the legal circumstances of the claims change.

Claims of U.S. commercial banks amount to about $1.9 billion, of which $1.6 billion are claims of the foreign branches and subsidiaries of the U.S. banks. Thus far we know of about $0.7 billion of direct investments in Iran and about $0.5 billion of other corporate claims. It would not be advisable while hostages are still held to initiate the procedure for establishing whether there are additional claims that might be forthcoming. U.S. Government claims on Iran amount to approximately $0.4 billion, about 80 percent of which are obligations due the Export-Import Bank. The only other significant U.S.G. claims are those due Treasury for World War II surplus property and AID. The total value of assets held in Iran -- that is real property -- apart from direct investment, is not known but is thought to be very small.

We are unable to estimate the assets of the Pahlavi Foundation or the Shah of Iran. Our reporting systems do not seek the identity of non-residents holding portfolio assets either in the United States or in foreign branches of U.S. banks. Nor do we have any information on the holdings of the Foundation or the Shah in other parts of the world.

Some transfer orders may have been initiated during the period between the government's announcement of its intent to withdraw funds from U.S. banks and the President's decision to block those assets, but the reports we have received do not suggest that there was any unusual activity during this period. Our blocking regulations permitted banks to honor checks of not more than $50,000 which were in the process of collection prior to our blocking announcement but which had not yet cleared. The regulations also permitted banks to pay persons other than Iran and Iranian entities from blocked accounts on documentary drafts drawn under irrevocable letters of credit issued or confirmed by a domestic bank prior to the date of the blocking, November 14. Also, Iranian deposits of foreign currencies in U.S. banks abroad which amounted to $0.3 billion were unblocked.

I hope you will find the above information of help.

Sincerely,

(Signed) Tony

Anthony M. Solomon

The Honorable
Frank Church
Chairman
Committee on Foreign Relations
United States Senate
Washington, D.C. 20510

MEMORANDUM

Date: November 14,

To: F. Lisle Widman

From: Jerry M. Newman

Subject:

Carswell thinks we have to try to get at least by the end of the week a much better fix on the amount of U.S. claims and liabilities vis-a-vis Iran which were outstanding at the time of the blocking action. The question of the position of the U.S. banks will come up at a meeting at 2:30 p.m. today which he is having with the Fed-OCC-FDIC which I am attending. He has already raised the question of how to get a fix on non-banks with the Commerce people this morning but apparently the way the discussion went this morning Carswell is not sanguine that they will be of much assistance. We need to sit down with Karlik, Keyser and company immediately to design a possible telephone survey of the C Form respondents. There are a lot of different kinds of data that are probably required, not all of which can be generated by the non-banks on short notice.

Inter-Office Memorandum

ACTION BRIEFING INFORMA

Date: February 1, 1980

For: Jerry Newman and Ida Mae Mantel

From: Dirck Keyser

Subject: Changes in Estimates of Iran's U.S. Assets as of November 14, 1979 (SRC-16)

Treasury estimates of Iranian assets in the U.S. or in the overseas offices of U.S. banks as of November 14 have changed very largely in reflection of the date of the data available to us at the time the estimates were made.

Our November 13 estimate, for example, was based on the most recently available data on Iranian deposits in the overseas branches of U.S. banks, those of June 30. However, Iranian deposits in these overseas offices were increasing significantly between June 30 and November 13, rising from $2,910 million on June 30 to $3,799 million in September 30 and $5,334 million on November 13. The September 30 data were not available to us until later in November, after the November 14 blocking order, and the November 13 data not until December 6, when they became available for most of the reporting banks. These changes account for 61% of the total change in Treasury estimates of all Iranian assets in the U.S. or the foreign offices of U.S. banks.

Changes have also resulted from changes in coverage as additional Iranian assets have been included in the figures. Iranian gold on deposit with the Federal Reserve, for example, was not included in the original figures, and accounts for 16% of the change. Iranian claims on the U.S. government account for an additional 10%.

OS F 10-01.2 (8-77) which replaces OS 3275 which may be used until stock is depleted.

Iranian Assets in the U.S. and the Foreign Offices of
U.S. Banks, as of November 13, 1979
(Millions of Dollars)

	November 13 Estimate	February 1, 1980 Estimate	Change	Reason
Overseas Offices of U.S. banks	2,450	5,334	+3,362	More recent da available
U.S. banks' domestic offices	460	938	+478	"
FRBNY deposits & Govt. securities	1,365	1,237	-128	"
Gold	--	636	+636	Broader Covera
Securities	35	1	-34	Private Holdin excluded
Claims on Corporations	525	273	-252	More recent da
Direct Investment	5	5	0	
Claims on U.S. Government	--	380	+380	Broader Cover
	4,840	8,804	+3,964	

to Charles Schotta
John Blaney

Department of the Treasury
Office of the Assistant Secretary for International Affairs

from ________ date 1/3/79

Attached is the paper you requested on Iran for the Newsom group.

Barry Newman

cc: Bergsten, Junz, Nachmanoff, Leddy,
Syvrud, Pelikan, Maresca

room
phone

Financial Implications of the Iranian Situation

I. Iranian Dollar Assets

The foreign exchange reserves of Iran as of the end of September were about $10.3 billion of which the U.S. embassy estimates that about two-thirds are in dollar denominated assets. Iranian foreign exchange holdings are heavily concentrated in the Euro-currency markets; only a small proportion is placed directly in the United States, and that is primarily in the form of U.S. Treasury securities. In addition, Iran has substantial foreign investments (e.g. prepayment of exports and commercial investments in LDCs and Europe) but in general these are not easily mobilized.

a) Vulnerability of U.S. banks: U.S. banks would not be particularly vulnerable to liquidity problems arising from a sudden withdrawal of Iranian deposits. If dollar deposits were shifted from U.S. banks to foreign banks, the recipient banks would have to find outlets for the additional funds. The normal procedure would be to offer these funds to the interbank market in which case the U.S. banks which had lost deposits could borrow them back. Even if the dollars are converted into foreign currencies, the purchaser of the dollars (including foreign central banks) would still have to place funds in dollar instruments. The funds would therefore still be available to U.S. banks. Any transitory liquidity problems that might emerge could be alleviated by bank borrowing from the Federal Reserve.

b) <u>Exchange market impact</u>: The latest political developments in Iran have been a disruptive factor in the foreign exchange markets. Although the U.S. is less dependent on Iranian oil than other major countries, the general market psychology for the dollar is weak and nervousness about the security of oil supplies has contributed at times to selling pressures on the dollar. An attempt by an Iranian government to switch official reserves from dollar instruments to other currencies would, of course, tend to place additional pressures on the dollar and hamper U.S. efforts to restore stability to the foreign exchange market.

There are important economic and financial constraints on Iran's ability and incentive to diversify its investment portfolio.

-- Dollar investments provide the wide range of financial assets and depth of capital markets most capable of accomodating Iran's investment needs. The other major countries which might provide alternative reserve investments are reluctant to have their currencies used as reserve assets and have discouraged access to their domestic capital markets, although there is scope for movement through the Euro-currency markets. It is likely that even if Iran withdrew deposits from U.S. banks, the bulk of its holdings would remain in dollar form.

-- Attempts by Iran to switch out of dollars which caused the dollar to depreciate would entail substantial capital losses on its reserves which remained in dollars. Moreover, dollar interest rates are higher than German, Swiss, and Japanese rates and a shift from dollar assets would result in reduced investment income at a time when oil revenues are dropping off and foreign exchange receipts are sorely needed.

-- There is little need for Iran to diversify out of dollars to maintain the security of its reserves. As noted, [redacted] of Iran's assets are actually held in the United States. The security of funds held abroad can be protected easily without changing currency denomination.

In the event that exchange market pressures do arise because of Iranian financial moves, cooperative financing arrangements among the major industrial countries -- including the joint intervention operations with Germany, Japan and Switzerland and the broader central bank swap network -- provide an effective mechanism and large resources for corrective action.

II. U.S. bank exposure in Iran

As of June 30, 1978, U.S. bank claims on Iran totaled about [redacted] of which roughly [redacted] represented claims on banks, [redacted] were claims on public borrowers and [redacted] represented claims on non-bank private borrowers. In addition, Iran has guaranteed about [redacted] in U.S. bank claims on other countries and has unutilized financing commitments from U.S. banks totalling [redacted].

Of the [redacted] in outstanding claims on Iran, [redacted] have a maturity of less than one year, [redacted] re 1-5 year maturities, and [redacted] represent maturities of more-than 5 years.

1/3/79

E. PROBLEMS WITH TREASURY'S INTERNATIONAL CAPITAL DATA COLLECTION SYSTEM

Inter-Office Memorandum

ACTION BRIEFING INFORMATIC

Date: March 31, 1978

R

For: Deputy Assistant Secretary Karlik

Return to Keyser
JK
5-IV-78

From: C. Dirck Keyser

Subject: Alternative Approaches for Improvement of C Form Data (SRP-24)

As you know, the FPIS consultants expressed the view during the January 23 meeting that the existing C Form data leave much to be desired. While I sought to avoid public embarrassment of Assistant Secretary Brill or International Economic Analysis at the time, I must say privately that we here in Statistical Reports heartily concur; indeed, this was the view of the Bernstein Committee in 1965 (see attached excerpt from that Committee's report).

We have done some work on the errors and omissions problem (SRP-46), and find that Professor William Branson of Princeton University, and a graph of the statistics (see enclosures), indicate that there is a good correlation between errors and omissions and foreign exchange market crises. Errors and omissions seem to represent unreported C Form flows into the Euromarkets when the dollar is under downward pressure, and out of the Euromarkets when it is under upward pressure.

<u>The Problems</u>

Basically, there are three problems with the C Form data:

(1) <u>Obsolescence of Forms</u>: The C Forms themselves are obsolescent. There had been no significant revision of them since 1964, which is to say since before the rise of the Euromarkets and a number of other international financial developments. We may thus be missing significant data from the best-intentioned reporters, simply because we are not asking the right questions.

(2) <u>Validity of data filed by current reporters</u>: The existing C Form reporters, some 950 non-bank commercial firms such as General Motors and Exxon, may have become somewhat inattentive to their C Form

	Initiator	Reviewer	Reviewer	Reviewer	Reviewer
Surname	Keyser	Lee			
Initials/Date	/3/31	/	/	/	/

CS F 10-01.2 (6-77) which replaces OS 3275 which may be used until stock is depleted.

responsibilities, probably relegating these duties to junior personnel unaware of the complexities of international finance or of the reporting firm itself. The 1965 Bernstein Committee Report noted that "firms ...sometimes submit incorrect data, for a variety of reasons: the transactions may be intricate, the corporate structure of the reporting institution may be complex, the reporting instructions may not be clearly understood, the relevant facts may not be easily obtainable from the reporter's records, and the reporter may in some cases be unable to identify a foreign resident as foreign. More generally, executives of some firms do not give adequate attention and support to a program that, while based on statutory authority, relies for its success on voluntary compliance rather than on penalties." This thirteen-year-old analysis is undoubtedly still valid.

(3) Adequacy of Coverage: There are undoubtedly firms with liabilities to and claims on foreign residents which do not file C Forms at all. Here again, the problem was commented upon by the Bernstein Committee, and has undoubtedly worsened since then as business and corporate finance have increasingly been internationalized by burgeoning international trade and investment and the rise of the Euromarkets.

Proposed Solutions

(1) The obsolescence of the C Forms is being treated by the contract given Mr. Callander to design a new Form; we plan to submit the new C Form to OMB by June 30, 1978, which should make improved nonbanking data available for analysis as of December 31, 1978, the "as-of" date of the FPIS.

(2) The other two problems (the validity of the data filed by current reporters and adequacy of coverage) must be attacked by some kind of benchmark survey effort. We envision two alternative approaches:

A. "FPI-3" Approach - Under this alternative, as suggested by David Devlin in the New York meeting on January 23, the revised Form C-1/2 could be sent out as a third form ("FPI-3") under the Foreign Portfolio Investment Survey.

Why are there alternatives

B. Federal Reserve Approach - The revised Form C-1/2, effective as of end year 1978, would be circulated to current and potential new reporters by the Federal Reserve Bank of New York under existing TIC data collection procedures.

Which - (Fed approach)

Such a canvass has been handled this way in the past, and is well overdue. The most recent one was undertaken in December, 1969, when some 3,700 nonbanking concerns were canvassed, using a mailing list bought by Treasury from Dun & Bradstreet. This effort was very successful, resulting in an increase of some 51 percent in the number of respondents and increases of 21 percent and 9 percent, respectively, in reported liabilities to, and claims on, foreigners. General canvasses were also carried out in 1962 and 1965. Both undertakings produced fairly sizable additions to the reporting group.

We believe that a new canvass of the business community is essential if the Treasury is to use with confidence the C-1/2 liabilities data in connection with other FPIS benchmark data. Among the findings of the 1974 Survey was that more than 700 firms indicated that they had liabilities to, or claims on, foreigners during 1974, but had not reported on Treasury Form C-1/2. In the Survey report we stated that reporters would be screened and contacted to determine whether they should be reporting. Staff constraints, however, prevented our followup on this promise.

Were the revised C-1/2 format to go out as part of the FPIS package (Alternative A), several problems would be involved:

1) The C-1/2 covers all nonbanks' liabilities and claims vis-a-vis nonaffiliated foreigners, whereas the 1978 FPIS is addressed only to U.S. portfolio liabilities. Moreover, we have taken the approach with Senator Inouye that unlike the 1974 FPIS, the 1978 study would not separately survey those items already covered on an ongoing and presumably adequate basis by the TIC B and C reports. Vs claims.

2) FPIS data would be reported to the Treasury on a confidential basis; hence, there could be problems in providing individual C-1/2 data to the New York Fed staff for cross checks, etc., against earlier C-1/2 reports filed by the same reporters.

3) Were "FPI-3" forms only applicable to nonbank firms not currently filing C-1/2's and the returns ~~processed~~ by the FPIS staff, statistical problems might arise in merging the "FPI-3" and C-1/2 data files as of the December 31 reporting date. what time

Early?

We believe that Alternative B ~~is~~ the better approach. We could make use of the FPIS mailing list to bring the reporting requirements of revised Form C-1/2 to the attention of current and prospective new reporters. This would keep the data within established reporting channels and likely produce better long-term results with respect to the completeness and accuracy of nonbanks' international portfolio capital data. The schedule we have established would also allow us to

Calendar?

give the New York Fed adequate notice of the canvass. The major problem here is one of adequate personnel resources both at the New York Fed and in this Office to manage the canvass and to monitor C-1/2 reporting on an ongoing basis. This Office lost in the fall of 1976 a mid-level staff economist whom we had assigned to concentrate on nonbanking reporting problems and concepts. During our recruiting efforts to fill the position the slot disappeared in the transition period. To maintain the TIC Reporting System on even an adequate basis, we desperately need to regain that slot.

On the New York Fed side, we have realized for some time that sufficient resources at the Bank were not allocated to the C-1/2 area. We have now some 950 quarterly respondents on that form and only three or four clerical people in New York monitor the data on a part-time basis. No professional in New York focuses full-time on the nonbank TIC reports.

In view of these considerations, I recommend the following actions:

1. That you authorize me to proceed with a survey of prospective new respondents on TIC Form C-1/2.

Approve John R. Karlik

Disapprove__________________

2. That for this purpose you authorize me to initiate negotiations with the New York Fed to expand their International Reports Staff in accordance with the demands of the canvass and for ongoing monitoring of the nonbank reports.

Approve John R. Karlik

Disapprove__________________

3. That you approve a recommendation to Assistant Secretary Brill that we seek restoration of the TIC C and S Form analyst's position at the GG-11 to GG-13 level.

Approve John R. Karlik

Disapprove

cc: G. Lee
L. Maley
T. Moran

Date: May 15, 1978

MEMORANDUM FOR: Assistant Secretary Brill

From: John Karlik

Subject: Treasury International Capital (TIC) C-Form Problems and Solutions

As you know, the FPIS consultants felt in January that the existing C Form data leave much to be desired. Dirck Keyser and I agree; this was indeed the view of the Bernstein Committee which reviewed balance of payments statistics in 1965 (attached is an excerpt from that Committee's report).

Statistical Reports (EIS) has done some work on the errors and omissions problem, and has found that both Bill Branson of Princeton and the statistics indicate a significant correlation between errors and omissions and foreign exchange market crises (see enclosures). Errors and omissions seem to arise from unreported C Form flows into the Euromarkets when the dollar is under downward pressure, and out of the Euromarkets when it is under upward pressure.

Basically, three problems seem to need treatment: the adequacy of the forms themselves, the adequacy of coverage, and the longer-term problem of quality control.

The adequacy of the forms will, we believe, be remedied by the new C Forms design which we hope to submit to OMB by June 30. We would hope for OMB clearance by about August 11, so as to send the new forms to reporters by about September 30. Data as of December 31 would thus be on the new forms.

The New York Fed has tentatively agreed to assist us with an attack on the problem of coverage by undertaking a canvass of putative new C Form reporters. We have agreed to try and provide them with a mailing list, which we would either buy from Dun and Bradstreet, as in the past, or obtain by other means; Statistical Reports is talking with Commerce on this subject currently. Such a canvass by the New York Fed in 1969 covered 3,700 nonbanking firms, using a Dun and Bradstreet list bought by Treasury. This effort was very successful, and

	Initiator	Reviewer	Reviewer	Reviewer	Reviewer	Ex. Sec
Surname	Keyser	Lee				
Initials / Date	CHM / 5/4/78	[illegible] / [illegible]	/	/	/	/

n OS-3129
rtment of Treasury

increased the number of respondents by about 51 percent; reported liabilities for foreign residents were increased by 21 percent, and claims by 9 percent. Similar canvasses were carried out in 1962 and 1965, and produced significant additions to the reporting group.

The longer-term problem of quality control of reports by existing reporters necessitates, we believe, more adequate staffing on a permanent basis. We believe that the TIC economist's position which was lost because it was vacant at the time of the personnel freeze last year should be restored. This would permit assignment of an economist to full-time concentration on nonbanking firms' reports on the C and S forms, and would greatly increase our capacity to communicate with the reporting firms, the Federal Reserve Banks and the Department of Commerce in order to solve reporting problems on a timely and constructive basis. The position would also restore the TIC staff to something resembling adequacy. This staff has been decimated by inattention in the past several years: in 1974 there were six TIC professionals, and now there are only two. While six may have been too many, two are clearly too few for the essential function of monitoring the data and performing reliable work on substantive reporting problems.

The additional burdens of coordination and review about to be placed on the TIC staff by the proposed 1978 canvass seem to me to require our moving on this front as soon as possible in order to have this economist on board this summer or fall. Such a move would necessitate our submitting a supplemental budget request.

RECOMMENDATION:

That you approve a supplemental budget request to support the addition as soon as possible of one TIC economist at the GG-11 to GG-13 level.

Approved ____________________

Disapproved ________________

Other ______________________

cc: G. Miller
D. Keyser
G. Lee

Keyser

OPTIONAL FORM NO. 10
MAY 1962 EDITION
GSA FPMR (41 CFR) 101-11.6
UNITED STATES GOVERNMENT

Memorandum

Department of the Treasury
Washington, D.C. 20220

TO : Cathryn Goddard

DATE: Sept. 29, 1978

R

FROM : Dirck Keyser DK

SUBJECT: Oil Exporter Placements (SRA-46)

We have reviewed the data contained in the attached memorandum from Don Curtis, as Tom Lovinger said John Karlik had suggested, and we find that we have no problem with the figures that Don has come up with; his data are from our data base. I would note that most of the swing in oil exporter placements occurred during the second quarter, a period for which our data are still in considerable turbulence as a result of the change-over from the old B forms to the new B forms: we are awaiting some 150 pages of corrections for these data from the Second District alone. It seems unlikely that these corrections will result in a reversal of the trend, however.

On the other hand, it is interesting that most of the reported swing occurs in Treasuries and bank deposits. Withdrawals from these accounts could reflect portfolio switching into other dollar investments as well as withdrawal from the dollar. There has been a slow movement by the oil exporters into longer-term securities, including common stocks, over the past two or three years, and it is conceivable that this trend accelerated somewhat during the second quarter. The data we have from the S forms, which track the securities markets and which are correctly represented in Don Curtis' table, do not give us much evidence of this (although they are consistent with a shift from bank deposits to stocks as far as they go).

On the other hand, we here have been puzzled by the fact that the widespread reports of heavy foreign buying in the U.S. stock market during the second quarter were not dramatically reflected in the S form data. It is interesting to note in this connection that unrecorded inflows during the first quarter amounted to $3.8 billion, and during the second accelerated to $8.0 billion; we may simply not be getting all the securities transactions on the S forms. If this is so, we could be observing reported withdrawals from short-term dollar holdings for transfer into unreported long-term dollar holdings.

All of the foregoing is of course highly speculative. I have discussed this with Dave Curry in OASIA, and he notes that there have indeed been increases in U.S. banks' foreign branches' liabilities to the oil exporting countries, which would reflect portfolio shifts into Euromarkets out of the U.S. -- possibly into Eurodollars, perhaps into other currencies. He seems to share my view that there could also be unrecorded portfolio shifts within the United States; his speculation in this realm extends not only to the possible unrecorded stock purchases which I have suggested, but also to commodities and real estate. He suspects that there may also have been some shift into other currencies, and I agree that this seems probable, too.

For the second quarter alone, a Commerce Department press release states that OPEC-held dollar assets in the U.S. decreased by $2.7 billion. The latter figure, however, relates only to official OPEC holdings and includes Government accounts data. In contrast, the decline for the second quarter in the Curtis memorandum is some $1.8 billion; however, the latter covers <u>both</u> official and private OPEC holdings in the U.S., denoting that the increase in OPEC countries' private U.S. assets (largely U.S. banks liabilities to unaffiliated banks in Venezuela) offset to some extent the decline in their official assets (primarily holdings of Treasury bills and bank deposits).

cc: J. Karlik
T. Lowinger
G. Lee
J. Kotze
D. Curtis
D. Curry

Inter-Office Memorandum

ACTION BRIEFING INFORMATION

Date: August 31, 1979

For: Deputy Assistant Secretary Karlik

From: C. Dirck Keyser

Subject: Second Follow-up letter to prospective Nonbank Reporters on TIC and TFC Forms.

The enclosed letters incorporate the changes you suggested in response to our August 27 memorandum.

RECOMENDATION: That you sign both the follow-up letter to prospective reporters on TIC and TFC Nonbanking Forms and the cover letter to Peter Fousek.

Agree JK 31 Aug 79

Disagree ______________

Other ______________

Attachments

	Initiator	Reviewer	Reviewer	Reviewer	Reviewer
Surname					
Initials/Date	/	/	/	/	/

OS F 10-01.2 (6-77) which replaces OS 3275 which may be used until stock is depleted.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

DEPUTY ASSISTANT SECRETARY

August 31, 1979

Dear Peter:

Congratulations on your appointment as Senior Vice President and best wishes for your continued success. I look forward to our continued collaboration in the areas where the Treasury and the Federal Reserve Bank of New York have overlapping responsibilities.

One of these areas, the collection and reporting of international capital flows, is a matter of some concern to the Treasury. As you may know, in the fall of last year there was an effort made to increase the size of the reporting panel for several Treasury International Capital (TIC) and Treasury Foreign Currency (TFC) Nonbanking Forms. Part of this effort consisted of the October mailing of letters and forms to approximately 8,000 potential new reporters. This was followed by a November 30 mailing of 5,000 letters to nonrepliers and additional potential reporters. This effort coincided with changes in the C-Series Forms used to collect nonbanking claims on, and liabilities to, foreigners. Copies of the canvass letters and reporting forms are enclosed.

In the interim, a great deal of the International Reports Division's time has been spent in communications with old and new reporters, explaining the new forms and verifying the accuracy of the reports. As a consequence of this effort, any further follow-up on outstanding replies been delayed. The latest estimate we have dates from the end of March and places the number of nonrepliers at between 1,000 and 1,500. As we approach the first anniversary of the initial mailing, we are fearful that a large number of nonrepliers will not be contacted again and therefore our reports will be open to questions of completeness.

For this reason, I urge you to expedite the mailing of the enclosed letter to those nonbanking concerns who have not replied to the two earlier requests to maximize our intended statistical coverage. I am sure you appreciate the importance of including all potential reporters in our system. I hope that if additional personnel are necessary to carry out this task, they can be assigned to it until completion.

Sincerely,

John R. Karlik

John R. Karlik

Mr. Peter Fousek
Senior Vice President and
Director of Research
Federal Reserve Bank of New York
33 Liberty Street
New York, New York 10045

Enclosures

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

DEPUTY ASSISTANT SECRETARY

TO NONBANKING BUSINESS CONCERNS WHICH MAY BE REQUIRED TO REPORT ON TREASURY INTERNATIONAL CAPITAL OR FOREIGN CURRENCY FORMS:

Our records indicate that you have not responded to two previous requests concerning certain Treasury Department reports which your organization may be required to submit.

The Treasury International Capital (TIC) C-series Forms are part of a statistical reporting system which provides data on capital movements between the United States and foreign countries. The Treasury Foreign Currency (TFC) Forms FC-3 and FC-4 are for reporting the foreign currency positions of U.S. nonbanking firms and their foreign branches and subsidiaries. Reports are filed with the Federal Reserve Bank of New York, which acts as the fiscal agent of the Treasury in collecting the data.

These reports form part of a data system used in the formulation of United States international financial and monetary policies and the preparation of the United States international accounts. As an indication of their importance, reports on these forms are required by law as specified by Title 31, Part 128 of the Code of Federal Regulations, which includes the following penalties: failure to report can result in a civil penalty not exceeding $10,000 (22 U.S.C. 3105; 31 U.S.C. 1143; 31 C.F.R. 128.4 (b)); willful failure to report can result in criminal prosecution and upon conviction a fine of not more than $10,000, or, if a natural person, imprisonment for not more than ten years, or both; any officer, director, or agent of any corporation who knowingly participates in such violation may be punished by a like fine, imprisonment, or both (12 U.S.C. 95a; 31 C.F.R. 128.4 (a)).

We ask that you carefully review both the Treasury International Capital Nonbanking Forms and the Treasury Foreign Currency Forms FC-3 and FC-4 that are enclosed. Questions about the instructions or the preparation of these forms should be telephoned to the International Reports Division of the Federal Reserve Bank of New York at (212) 791-6736 or (212) 791-5558. After careful review please write to the Federal Reserve Bank of New York, even if you are not required to file any of the several forms, and specify which forms you are exempt from filing and which you will start to file. You may reply on your letterhead or on the notification sheet enclosed for your convenience. If you submit data to your parent firm or head office for inclusion in its reports currently filed, please notify the Federal Reserve of New York. Replies should be addressed as follows:

International Reports Division
Room 929
Nonbanking Forms Notification
Federal Reserve Bank of New York
33 Liberty Street
New York, New York 10045

Firms required to file any report will be furnished a supply of that form. Initial reports should be filed reflecting data as of December 31, 1978.

As this is the third request we expect a prompt reply.

Sincerely,

John R. Karlik

John R. Karlik

Enclosures

UNITED STATES GOVERNMENT

Memorandum

Department of the Treasury
Washington, D.C. 20220

DATE: Sept. 29, 1978

TO : Cathryn Goddard

FROM : Dirck Keyser

SUBJECT: Oil Exporter Placements (SRA-46)

We have reviewed the data contained in the attached memorandum from Don Curtis, as Tom Lowinger said John Karlik had suggested, and we find that we have no problem with the figures that Don has come up with; his data are from our data base. I would note that most of the swing in oil exporter placements occurred during the second quarter, a period for which our data are still in considerable turbulence as a result of the change-over from the old B forms to the new B forms: we are awaiting some 150 pages of corrections for these data from the Second District alone. It seems unlikely that these corrections will result in a reversal of the trend, however.

On the other hand, it is interesting that most of the reported swing occurs in Treasuries and bank deposits. Withdrawals from these accounts could reflect portfolio switching into other dollar investments as well as withdrawal from the dollar. There has been a slow movement by the oil exporters into longer-term securities, including common stocks, over the past two or three years, and it is conceivable that this trend accelerated somewhat during the second quarter. The data we have from the S forms, which track the securities markets and which are correctly represented in Don Curtis' table, do not give us much evidence of this (although they are consistent with a shift from bank deposits to stocks as far as they go).

On the other hand, we here have been puzzled by the fact that the widespread reports of heavy foreign buying in the U.S. stock market during the second quarter were not dramatically reflected in the S form data. It is interesting to note in this connection that unrecorded inflows during the first quarter amounted to \$3.8 billion, and during the second accelerated to \$8.0 billion; we may simply not be getting all the securities transactions on the S forms. If this is so, we could be observing reported withdrawals from short-term dollar holdings for transfer into unreported long-term dollar holdings.

All of the foregoing is of course highly speculative. I have discussed this with Dave Curry in OASIA, and he notes that there have indeed been increases in U.S. banks' foreign branches' liabilities to the oil exporting countries, which would reflect portfolio shifts into Euromarkets out of the U.S. -- possibly into Eurodollars, perhaps into other currencies. He seems to share my view that there could also be unrecorded portfolio shifts within the United States; his speculation in this realm extends not only to the possible unrecorded stock purchases which I have suggested, but also to commodities and real estate. He suspects that there may also have been some shift into other currencies, and I agree that this seems probable, too.

For the second quarter alone, a Commerce Department press release states that OPEC-held dollar assets in the U.S. decreased by $2.7 billion. The latter figure, however, relates only to official OPEC holdings and includes Government accounts data. In contrast, the decline for the second quarter in the Curtis memorandum is some $1.8 billion; however, the latter covers both official and private OPEC holdings in the U.S., denoting that the increase in OPEC countries' private U.S. assets (largely U.S. banks' liabilities to unaffiliated banks in Venezuela) offset to some extent the decline in their official assets (primarily holdings of Treasury bills and bank deposits).

cc: J. Karlik
T. Lowinger
G. Lee
J. Kotze
D. Curtis
D. Curry

F. PROBLEMS WITH FEDERAL MONITORING OF FOREIGN PORTFOLIO INVESTMENT IN U.S. PARTNERSHIPS AND SUGGESTED SOLUTIONS

January 30, 1980

Mr. Karlik

David Curry

Foreigners' Portfolio Investment in U.S. Partnerships--
Contract with Chester L. Callander

Attached for your review is a final report from Chester L. Callander regarding foreigner's portfolio investment in U.S. partnership interests. Part I of the report, previously submitted as a preliminary report, assesses the Treasury International Capital (TIC) reporting system as a vehicle for collecting data on such portfolio investment. Part II evaluates the feasibility of obtaining from the Internal Revenue Service (IRS) statistical tabulations of foreigners' portfolio investment in U.S. partnership interests based upon partnership tax return data files.

Highlights of the report include the following:

1. Portfolio investment, as defined in the International Investment Survey Act of 1976, includes general partnership interests of less than 10% and all limited partnership interests.

2. The TIC reporting system does not presently capture foreign portfolio investment in U.S. partnerships. Present TIC report forms do not provide a means for reporting of portfolio investment in general partnerships. Investments in limited partnership interests are, in principle, reportable on TIC Form S. However, in practice, Form S reports are primarily limited to data on transactions in types of securities for which there is an active secondary market; active secondary markets for limited partner interests do not exist. It would be necessary to either modify existing report forms or develop a specialized report form for partnership interests in order to capture such portfolio investment through the TIC reporting system.

CURRY MALEY

3. The costs of identifying and locating prospective reporters (partnerships) and of maintaining such an addition to the TIC reporting system could be substantial. Available information on the value of U.S. partnership interests, or of foreigners' portfolio investment in such interests, is insufficient to serve as a reliable guide toward potential benefits from expansion of the TIC reporting system.

4. Data reported to the IRS on tax form 1065 and schedule K-1, if summarized and analyzed appropriately, could be used to develop an estimate of foreigners' portfolio investments in U.S. partnerships. However, the information is not now recorded in IRS computer files to the extent necessary to accomplish this objective.

5. With one exception, the lead time required to modify IRS computer files and processing procedures would prohibit development of data from IRS files in a form suitable to serve as a supplement to the 1978 survey of foreign portfolio investment in U.S. securities (FPIS). The one IRS computer file system of possible use to FPIS is the Statistics of Income file derived from a stratified, systematic sample of partnership tax returns. The sampling procedure used to construct this data file provides comprehensive coverage of those types of partnerships thought most likely to attract foreign investment.

6. A rough estimate of foreigners' portfolio investment in U.S. partnerships, as of end-1978, could be generated from tax returns filed in 1980. To obtain this estimate from IRS, it would be necessary to define our data requirements for the IRS (and possibly obtain their concurrence in the task) by March 31. Costs of the tentative project can not be determined until the prospective new data requirements are defined and a formal proposal submitted to IRS. The potential estimate would not be available prior to April, 1981.

The report, in my judgement, completely satisfies all performance requirements specified in Mr. Callander's contract with Treasury. Accordingly, I have prepared for your signature a memorandum (attached) to Karen Anderson requesting that she authorize disbursement of the $2,594.00 requested by Mr. Callander in payment for his services.

Recommendations:

1. that you sign the attached memorandum to Karen Anderson.

2. that you authorize development of a specific project proposal for the IRS's Statistics of Income Division to computerize and tabulate foreigners' portfolio investments in U.S. partnerships reflected in their anticipated sample of partnership tax returns filed in 1980.

Approve: ______________________

Disapprove: ______________________

[illegible]

cc: Mr. Keyser

REPORT ON

FOREIGN PORTFOLIO INVESTMENT IN PARTNERSHIP INTERESTS

IN THE UNITED STATES

Prepared for the Department
of the Treasury by
Chester L. Callander
January 28, 1980

FOREIGN PORTFOLIO INVESTMENT IN PARTNERSHIP INTERESTS IN THE UNITED STATES

INTRODUCTION

This report on foreign residents' portfolio investment in the United States in the form of partnership interests - i.e., limited partnership interests (LPIs) and general partnership interests of less than ten percent ownership (GPIs) consists of two parts:

Part I is an assessment of the extent to which data on foreign portfolio investment in partnership interests in the United States are included in reports filed by brokers, banks, and other business firms in the United States on the Treasury International Capital (TIC) Forms, and a provisional evaluation of the appropriateness of the TIC forms as a means of obtaining statistical reports of such investment.

Part II is an assessment of the extent to which data on the outstanding amount of foreigners' portfolio investment in partnership interests in the United States are recorded in the Internal Revenue Service data files derived from partnership tax returns, and of the feasibility of obtaining from the IRS a tabulation of such foreign investments in a form which could supplement the Foreign Portfolio Investment Survey (FPIS).

PART I

INFORMATION IN TREASURY INTERNATIONAL CAPITAL REPORTS ON FOREIGN PORTFOLIO INVESTMENT IN PARTNERSHIP INTERESTS

General Partnership Interests

General partnership interests of less than ten percent ownership (GPIs) are included in the concept of foreign portfolio investment in partnership interests, the subject of the study. Not much can be said about GPIs at this stage, however. The present statistical reporting system does not include data on GPIs. The present TIC report forms provide data on some types of foreign assets in the United States and on foreign purchases of U.S. securities, but identify only the country of residence of the foreigner, and contain no information on the extent of foreign ownership in individual U.S. enterprises. The B-forms filed by banks and the C-forms filed by nonbanking firms exclude equity positions, and the S-form covers only securities, which do not include general partnership interests. Consequently foreign investments in GPIs are not covered by the present TIC reports.

This is a formal gap in the statistical system, but it may not be a significant one. The investment vehicles most frequently mentioned in connection with the oil and gas industry, for example, are LPIs and joint ventures. Joint ventures in which ownership by a foreigner is ten percent or more represent foreign direct investment rather than foreign portfolio investment. Considerable investigation would be required to develop an estimate of the extent of general partnership interests of less than ten percent foreign ownership (GPIs), which would represent foreign portfolio investment. This could involve a specific provision for reporting GPIs, as suggested below, or an attempt to obtain data on GPIs from the IRS data files, outlined in the second part of this report.

For the reasons outlined above, Part I of this report deals primarily with foreign investment in LPIs.

Characteristics of Limited Partnership Interests

Limited partnership interests are a form of equity investment in a partnership in which the partner has no voting rights in the control of the enterprise, and has a limited liability. Because of the absence of voting rights, limited partnership interests (LPIs) are expressly excluded from the Department of Commerce definition of direct investment. LPIs are expressly included in the Securities and Exchange Commission definition of equity security. Conceptually they fall within the scope of the TIC reporting system.

Public offerings of LPIs are registered with the SEC and some of them are marketed initially through brokers and dealers. Normally there is no secondary market. The investor can sell only with the consent of the general partner, which involves the admission of the new investor as a limited partner. There is usually provision for resale of the LPI to the general partner, subject to limitations as to the time of the resale and subject to quantitative limitations on the amount resold.

The bulk of foreign investment in LPIs is thought to take place through private offerings. Private offerings are exempt from the SEC registration requirements, although they may be reported in filings under Rule 146, which is essentially a declaration that a private offering has occurred, and provides information on the amount of the offering and the identity of the offerors.

The principal issuers of LPIs are thought to be oil and gas and real estate firms.

Present Reporting Situation

Conceptually, transactions with foreigners in LPIs are one of the types of international capital movements that are measured by the TIC reporting system, and in principle could be considered reportable on TIC Form S. Form S requires all banks, banking institutions (including bank holding companies), brokers, dealers or other persons in the United States who on their own behalf or on behalf of their customers engage in transactions in long-term securities directly with foreigners, to report the amounts of such transactions for any month in which the aggregate of foreign purchases and sales amounts to $500,000 or more. "Long-term" securities are defined as those having no contractual maturity (e.g., stocks) or a maturity of more than one year from date of issuance. The instructions specify that the term "securities" should be interpreted broadly and should include privately as well as publicly offered issues. While the Form S instructions would appear to cover LPIs as a form of equity security, LPIs are not expressly mentioned; and the specific instruction applicable to the columns dealing with transactions in domestic stocks refers only to stocks issued by private corporations.

The report form filed by banks on their custody liabilities to foreigners--TIC Form BL-2--covers assets held in custody for foreign owners, but expressly excludes long-term securities from the items to be reported. LPIs are, therefore, not reportable by banks. If a foreign-owned LPI certificate held in custody by a bank did not have the appearance of a long-term security, it might be reported in error as a custody liability to a foreigner. This seems unlikely, however.

The report of financial liabilities to foreigners filed by nonbanking firms on TIC Form CQ-1 excludes foreign equity holdings in the reporting company. Even though LPIs are not expressly mentioned in the list of items to be excluded, it seems unlikely that treasurers of reporting companies would include foreign holdings of LPIs issued by the company as a financial liability.

In November 1979, the TIC reporting staff of the Federal Reserve Bank of New York asked 22 major securities firms which report on Form S whether they had effected any foreign purchases of LPIs issued by U.S. firms, and whether they had reported any foreign purchases of LPIs on Form S. Only one firm had undertaken transactions with foreigners in LPIs: $300,000 in 1978 and $70,000 in 1979, representing investments in real estate enterprises in the United States, but these transactions were not reported on Form S. The rest of the firms indicated that they had not undertaken any transactions with foreigners in LPIs.

In addition to broker/dealers and banks, the Form S reporting requirement extends to other persons in the United States who deal directly with foreigners in long-term securities transactions without using the services of a broker or bank in the United States. Some nonbanking firms report on Form S their offshore sales of securities to foreign purchasers, or their purchases of foreign securities directly from foreign issuers. It has been difficult to ensure full reporting of such securities transactions even by large firms, because these are not frequently recurring transactions and the firms may therefore overlook the Form S requirements, even though they may be regular reporters on the TIC C-forms. The difficulty of obtaining reports would presumably be even greater in the case of the numerous oil and gas and real estate firms which are believed to be the most important issuers of LPIs.

The firms other than brokers and banks which have reported on Form S in recent years include a number of oil firms, some of which could be issuers of LPIs. The Form S reports filed by such firms during the years 1976-1979 (five oil companies) were examined by the TIC staff of the New York Federal Reserve Bank to determine whether the securities involved were debt or equity securities. All of the transactions reported were in debt obligations, indicating that no LPIs were involved.

It appears that despite the characteristics of LPIs as equity securities, transactions with foreigners in LPIs are not being reported on Form S. The most likely explanation appears to be the absence of a secondary market for LPIs.

The bulk of the transactions reported on Form S is reported by securities firms operating in the organized markets for stocks and bonds. These firms offer new issues on behalf of issuing corporations, but most of their transactions are in the secondary market for these securities. The transactions reported on Form S by other firms represent their own new offshore issues of debt obligations, or their direction acquisitions of new foreign issues for investment purposes, and similar direct transactions with foreigners. While Form S is not formally limited to transactions in marketable securities, in practice the S-form data cover mainly, if not entirely, transactions in types of securities for which there is an active secondary market.

In terms of their marketability and the way in which they are offered, LPIs are different from the types of securities traded in the organized markets. While some firms which issue LPIs use broker/dealers for the distribution of their public issues, the bulk of the LPIs are said to be issued privately, and even the publicly offered issues are not traded in the secondary market. Under these circumstances, the S-form cannot capture transactions with foreigners in LPIs.

Use of TIC System for LPI Reporting

There is apparently no institutional characteristic which is common to issuers of LPIs which could provide a central structure on which to base a reporting requirement, such as the securities exchanges for Form S reporters and the banking system for B-form reporters. The LPI situation is similar to that of the C-form reporters, for which good reporting coverage requires frequent communication with a large number of firms in a variety of industries.

One possible approach would be to use one of the existing TIC forms for the reporting of LPIs--either the S-form, with appropriate modifications, in keeping with the identity of the LPI as a form of equity security, or Form CQ-1, modified to accommodate LPIs viewed as a special form of financial liability. The LPI situation, however, appears to be different from the S-form and C-form situations: it involves only one form of financial relationship rather than the broad range of types of securities and assets and liabilities covered by the existing TIC forms; it probably involves a much smaller number of foreign countries than the 77 individual countries listed on the present TIC forms; and it involves types of prospective reporters different from those covered by the existing TIC forms.

Another way of obtaining data on foreign investment in LPIs through the TIC reporting system would be to develop a specialized report form to be addressed to individual firms which issue LPIs. Such a form could be relatively simple, possibly with no printed country stub, and probably could be filed less frequently than Form S. The absence of a secondary market for LPIs and the relative stability of investments in LPIs suggest that reporting frequency could be based on what is needed for the balance-of-payments statistics--no more frequently than quarterly, or even annually if the aggregate amounts turned out to be relatively small. These aspects suggest that such a form could obtain the outstanding amounts of foreign investment in LPIs on the report dates, rather than gross purchases and sales during the period between reports. It would be useful if the form could distinguish between changes in position arising from accounting revaluations and those arising from actual movements of funds. It would also be useful to cover general partnership interests of less than 10 percent ownership (GPIs) as well as LPIs--perhaps shown separately--since these are included in the definition of portfolio investment.

While such a new report form would presumably be simpler than the present TIC forms, and while the reporting group might at least initially be limited to oil and gas and real estate ventures, the task of identifying and locating prospective reporters and of developing adequate reporting instructions would be substantial. The cost of maintaining and operating such an addition to the TIC reporting system would probably also be substantial. Consideration of requiring reporting of LPIs on a recurring basis would require some notion of the magnitudes involved, and some idea of the probability of obtaining reasonably reliable results.

The LPI Reporting Problem

Some preliminary observations on the nature and possible magnitude of the LPI problem are presented as background for further consideration of these questions. These observations arise from inquiries made concerning the use of LPIs, primarily in the oil and gas industry, and from less extensive inquiries concerning the real estate industry. These inquiries provide a basis for the provisional evaluation of the use of the TIC forms for reporting of LPIs, as outlined above. A great deal of additional investigation would be necessary to provide the basis for decisions on actual reporting arrangements, if it proved necessary to move in that direction.

Possible magnitudes --

No compilations have been found of the outstanding amount of foreign investment in the oil and gas industry in the form of LPIs. Industry sources indicate that a substantial amount of foreign investment in the U.S. oil and gas industry has occurred since the run-up in petroleum prices beginning in 1973-74, but the impression is not quantified, and does not distinguish between direct and portfolio investment.

A compilation of amounts raised through public oil program funds is released annually by Resource Programs, Inc., an investment adviser which concentrates on the oil and gas industry. These figures represent original subscriptions, excluding assessments, by all investors, domestic and foreign, in oil programs. These are defined as limited partnerships, joint ventures or other vehicles formed for the exploration, development or purchase of a diverse number of oil and gas properties which are generally not specified. The data also include relatively small amounts of offerings of fractional undivided interests in specific oil and gas tracts. Figures for recent years, as published in Oil and Gas Journal, March 19, 1979, are (millions of dollars):

1978	676
1977	539
1976	359
1975	322

Another industry source estimates the 1979 figure to be about $800 million. These figures relate only to public offerings, and do not show the amount of foreign participation. The second industry source cited above estimates private market offerings during 1979 at about $1,200 million. The same source estimates 1979 foreign investment in U.S. oil and gas at approximately $250 million, without distinguishing between direct and portfolio investment.

Private offerings are said to constitute the bulk of the amounts invested in the oil and gas industry. The only private offerings on record with the SEC are those reported under Rule 146. The Rule 146 reports identify the issuer and its chief executive officer, general partners, promoters and controlling persons; the organizers, promoters, sponsors and offeree representatives involved in the offering; the class of security offered; and the aggregate amount of the offering. The investors are not identified.

Other private offerings--those not reported under Rule 146--may raise the largest amounts of investment funds, and may involve the bulk of foreign participation. There is apparently no central repository of information on these private offerings, which are exempt from SEC registration requirements.

The development of comprehensive data on foreign investment in the real estate industry may be more difficult than in the oil and gas industry. The real estate industry encompasses a number of different types of activity which appear to offer a variety of investment arrangements. The geographic spread of real estate projects in which foreign investment may occur is probably greater than in the oil industry. A good deal of foreign investment in U.S. real estate represents direct rather than portfolio investment. A considerable amount of such direct investment is reported to the Department of Commerce, but it is not known how complete this reporting is.

Direct investment vs. portfolio investment --

Estimates of the amounts of foreign investment in industries in the United States, such as oil and gas and real estate, may fail to distinguish between direct and portfolio investment. While this distinction is not needed for the general purpose of estimating the extent to which foreigners have invested in the United States, the distinction is essential in a discussion of the problem of statistical reporting.

Direct investment is defined as the ownership or control, directly or indirectly, by one person of 10 percentum or more of the voting securities of an incorporated business enterprise or an equivalent interest in an unincorporated business enterprise. Statistics on direct investment are collected by the Bureau of Economic Analysis, in the Department of Commerce.

Portfolio investment is defined as any international investment which is not direct investment. Investment in LPIs, and in GPIs (less than 10 percent ownership), are forms of portfolio investment. Statistics on other types of portfolio investments are collected by the Treasury Deparment.

In considering the significance of round estimates of the amount of foreign investment in a U.S. industry, it is essential to determine the nature of the investment and the extent of each type, in order to draw valid conclusions on the statistical reporting aspects of the investments.

Intermediaries --

One problem which will arise in any effort to obtain reasonably complete figures on foreign investment in LPIs is that some foreign investments are made through domestic intermediaries or nominees. These may be law firms or other representatives, or they may be U.S. corporations organized to serve as intermediaries. If nominees or intermediaries are involved in a foreign investment situation, the firm in which the investment is made may not know or may be unwilling to reveal that a foreign investor is involved, or the nationality of the foreign investor. The intermediaries themselves may be hard to locate. This is believed to be a problem in present reporting in the TIC system, and might well be a substantial difficulty in LPI reporting in the oil and gas and real estate industries, particularly in situations in which the foreign investor may wish to avoid identification in his own country as an investor in the United States.

Sources of information --

A number of sources have suggested that substantial information on public and private LPI offerings in the oil and gas industry may be filed with the securities regulatory agencies of the States in which the investments are sold; and that information on oil and gas drilling operations is filed with the production regulatory agencies of the States in which the drilling occurs. There are national associations of the two kinds of regulatory bodies that may have useful information. It would require a substantial effort to explore these sources. It seems unlikely that they would provide comprehensive information on foreign investment in the industry, but they may provide useful clues.

It has also been suggested that useful information on the amount of foreign investment in U.S. industries--e.g., oil and gas and real estate--might be obtained from investment firms in countries in which significant amounts of foreign investment originate. Germany and Japan have been mentioned as sources of such investment and as possible sources of such information.

PART II

INFORMATION IN INTERNAL REVENUE SERVICE DATA FILES ON FOREIGN PORTFOLIO INVESTMENT IN PARTNERSHIP INTERESTS

A substantial amount of information relating to foreign portfolio investment in partnership interests in the United States is recorded on tax returns required by the Internal Revenue Service.

The Partnership Return

Form 1065, U.S. Partnership Return of Income, contains information on the partnership itself, the U.S. enterprise in which the foreign partner invests. Some of this is similar to the descriptive information shown on Part I of Form FPI-1, which describes the characteristics of the corporation which issues securities.

Schedule K-1, an attachment to Form 1065, provides information on each partner's share of the partnership's assets, liabilities, income, etc., which could provide data similar in some respects to that included in Schedule A of Form FPI-1.

The information recorded on Form 1065 and Schedule K-1 would, if summarized and analyzed appropriately, constitute a record of foreign investment in limited partnership interests (LPIs) and general partnership interests of less than ten percent ownership (GPIs), that would be a useful supplement to the FPIS. The information, however, is not now recorded in the IRS computer files to the extent necessary to serve this purpose.

Tax Administration Data Systems

The extent to which tax return data are recorded in the computerized IRS data systems is governed primarily by the needs of the IRS in collecting the tax revenues and enforcing the tax laws. The IRS computer systems are oriented toward the IRS' tax administration functions, and contain only the information needed for tax administration--for example, information identifying the taxpayer, information needed to determine correct tax liability, and information facilitating review of returns pertaining to particular situations such as tax shelters. Some of the information from partnership returns pertaining to foreign portfolio investment is recorded in the IRS data files; but none now contains sufficient information on partnerships and partners to permit the development of data in a form and to a degree of completeness that would serve as a supplement to the FPIS.

With enough lead time, it might be possible to introduce changes in these computer systems to yield information that would be useful to the FPIS, and to introduce additional questions on the tax forms for the same purpose. In principle, this would be a means of obtaining complete data on the basis of 100 percent of the tax returns rather than data based on a sample. The necessary lead time would be considerable. Systems changes require a minimum lead time of 18 months. By December 1979 the computer programs for processing the 1979 tax returns had been completed and tested, and the tax forms and programs for the 1980 tax returns are already in the process of development. The earliest possible changes in the forms and computer systems for the purpose of yielding information useful to the FPIS would have to be introduced into the programs for processing the 1981 tax returns, and the results would not be available until sometime in 1982.

A realistic appraisal indicates that elaboration of tax forms and the introduction of changes in the basic IRS computer systems for FPIS purposes would have to be planned far ahead, possibly looking toward the schedule for the next required survey, and that there is no possibility of using these data systems to provide a supplement to the current FPIS. The question of whether the IRS would accept such changes in its forms and systems has not been explored.

The Statistics of Income Program

The Statistics of Income (SOI) Program is oriented toward the production of data of general economic interest rather than for tax administration, on the basis of a sampling procedure.

The SOI file relating to partnership returns is derived from a stratified systematic sample which for the 1977 tax year consisted of approximately 41,500 partnership returns (Forms 1065) with approximately 930,000 accompanying Schedules K-1. The sample is selected on the basis of the absolute value of the net receipts, total income or loss, and total assets of the partnership, and is designed to be representative of the partnership population filing Forms 1065. The file contains data reported on Form 1065 pertaining to the partnership, but apart from examining the Schedules K-1 to determine the number of limited partners, does not include data from Schedule K-1, pertaining to the partners.

The computer programs for the analysis of the 1979 SOI partnership file are still open to the introduction of additional data and procedures of interest to FPIS, so that it might be possible to obtain data on foreign partnership interests from the SOI program in a form that would supplement the current FPIS. This would require the development of specifications for the data items desired by March 31, 1980, and of plans for tabulation of the results by December 31, 1980.

The Statistics of Income Sample

The SOI sample of partnership returns contains in round numbers something more than 41,500 returns out of an estimated population of about 1,200,000 partnerships. The sample is stratified on the basis of the absolute amounts of the partnerships' net receipts, total income or loss, and total assets. The sampling rate for each stratum increases with the size of the stratification criteria, and is 100 percent for the top two strata. The sample, therefore, is heavily weighted toward the larger firms. Table 1 presents details of the relevant data for the 1976 sample strata for partnerships.

For the 1976 tax year the number of returns in the sample was only 4 percent of the population of partnerships. For firms with receipts, income/loss or assets of $5 million or more (strata 6 and 7) the sampling rate was 100 percent; these firms had 40 percent of the assets of all partnerships tabulated. The sampling rates in strata 4 and 5 were 20 percent and 38 percent, respectively. Firms in the top four strata (4-7) held 46.5 percent of the assets of all partnerships tabulated.

The FPIS exemption level of $2 million of assets lies within strata 4 and 5. Because of the multiple basis of the SOI strata definitions, the precise point of correspondence between the SOI sample strata and the FPIS exemption level cannot be determined, but the data given above indicate that the SOI sample for 1976 would have given very substantial coverage to partnerships within the FPIS reporting population of firms with assets of $2 million or more.

The sampling instructions to be used during 1980 to sample the 1979 partnership returns involve a higher sampling rate for the larger firms and a lower rate for the smaller firms than was the case for the 1976 returns. The 1979 sampling plan is summarized in Table 2.

A precise determination of the point of entry of the FPIS exemption level remains impossible. A tabulation of strata 4 through 8 would include all firms above the FPIS exemption level of $2 million of assets, plus an unknown number of firms in categories 4 and 5 with assets between $1 million and $2 million. The presently planned sampling rates in stratum 5 are 20 percent for industry code 6511[1] and 34 percent for other industry codes; the planned rates for stratum 6 are 50 percent for code 6511 and 100 percent for other codes; and

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[1]Real Estate Operators (except Developers) and Lessors of Buildings. In the 1976 SOI sample, code 6511 firms numbered about 25 percent of total partnerships. The relative importance of code 6511 firms among partnerships with foreign partners is not known.

TABLE 1 - 1976 PARTNERSHIP RETURNS
Number of returns in population and in sample, sampling rates and amounts of assets

Sample stratum: Business receipts and total income/deficit	Sample stratum: Total assets	Number of returns: Population	Number of returns: Sample	Sampling Rate (percent)	Total Assets ($million)	Sample Assets ($million)	Percent of total assets
Both under $200,000	Not reported or under $100,000	810,605	10,507	1.3	n.a.	184	0.1
Both under $200,000	$100,000 under $1,000,000	189,148	8,232	4.4	n.a.	2,689	1.0
Both under $1,000,000 and at least one $200,000 under $1,000,000	Not reported or under $1,000,000	90,777	7,242	8.0	n.a.	839	0.3
Both under $1,000,000	$1,000,000 under $5,000,000	33,774	6,693	19.8	n.a.	13,021	5.0
Both under $5,000,000 and at least one $1,000,000 under $5,000,000	Under $5,000,000	13,738	5,275	38.4	n.a.	3,828	1.5
Both under $5,000,000	$5,000,000 or more	8,106	8,106	100.0	n.a.	104,761	40.0
At least one $5,000,000 or more	Any amount						
Total, strata 4-7		55,618	20,074	36.1	n.a.	121,610	46.5
Total, all strata[1]		1,153,784	46,607	4.0	261,605	125,322	47.9

[1] Includes sample of 552 returns from population of 7,636 returns sampled under plan applicable to prior year; these returns not included in detail of table.

Source: Internal Revenue Service, Statistics Division.

TABLE 2 - 1979 PARTNERSHIP RETURNS
Planned number of returns in sample, and planned sampling rates

Sample stratum: Net receipts and total income/deficit	Sample stratum: Total assets	Industry Code 6511[1]: Sample rate (percent)	Industry Code 6511[1]: Sample number	Other Industry Codes: Sample rate (percent)	Other Industry Codes: Sample number	All Industry Codes - sample number
Both under $200,000	Not reported or under $100,000	0.6	60	1.1	110	170
Both under $200,000	$100,000 under $1,000,000	1.7	170	4.1	410	580
Both under $1,000,000 and at least one $2,000 or over	Not reported or under $1,000,000	3.8	380	6.7	670	1,050
Both under $1,000,000	$1,000,000 under $5,000,000	7.8	780	19.0	1,900	2,680
Both under $5,000,000 and at least one $1,000,000 or over	Under $5,000,000	20.0	2,000	34.0	3,400	5,400
Both under $5,000,000	$5,000 under $25,000,000	50.0	5,000	100.0	10,000	15,000
Both under $5,000,000	$25,000,000 or over	100,0	10,000	100.0	10,000	20,000
At least one $5,000,000 or over	Any amount					
Total, strata 4-8			17,780		25,300	43,080
Total, all strata			18,390		26,490	44,880

[1] Real estate operators (except developers) and lessors of buildings.
Source: Internal Revenue Service, Statistics Division.

the planned rate for strata 7 and 8 is 100 percent of the population in those strata. It would appear that the planned sample for 1979 returns would provide more comprehensive coverage of firms with assets of $2 million or more than the 1976 sample, and would therefore constitute an adequate foundation for a tabulation of information useful to the FPIS.

Use of the SOI Sample File to Produce a Supplement to the FPIS

A possible means of obtaining data on foreign investment in partnership interests in the United States from the SOI sample of partnership returns for 1979 is outlined below.

It is important at the outset to take note of the numerous problems that can be perceived in the use of the SOI sample for this purpose.

For one thing, the SOI file is a sample, while the FPIS reports in principle represent the totality of a defined reporting universe. While the SOI sample provides reliable estimates, it is possible that differences will arise from the circumstance that the SOI sample is on a different statistical basis from the FPIS data.

A number of problems may be inherent in the use of data from one system for purposes of a different system. For example, there may be definitional differences between the IRS and the FPIS in some data items; there may be differences in accounting periods as between the IRS returns and the FPIS reports; and the industry codes used by the IRS do not coincide in all respects with the activity codes used in the FPIS reports. Problems of this sort are unavoidable, and their significance and effect are difficult to estimate.

There is a possibility that some Forms 1065 and Schedules K-1 may not be completely filled out, or that some may be inaccurate or have internal inconsistencies. The opportunities for obtaining corrections through follow-up procedures with the reporting partnerships may be less for the tax returns than for the FPIS reports.

The editing by the IRS staff for FPIS purposes may be affected by lack of familiarity of the editors with the FPIS system and objectives, and by lack of involvement by the FPIS professional staff.

It may prove impossible to detect and identify all situations which should be classified as direct investment. The accuracy of such classification would depend on the accuracy of the reports on Schedule K-1 of the percentage of foreign ownership.

A possibly serious problem is that under some circumstances, parties involved in joint production, extraction, investment, or use agreements that did not involve selling services or property produced or extracted could elect not to be considered as partnerships for tax purposes.[1] In such cases, no return is filed for the group, so that no data are available for the SOI statistics. The IRS does not know the extent of these situations, but it is believed to be significant for petroleum exploration and production. Since it is believed that substantial foreign investment has occurred in LPIs in oil and gas exploration, this may be a significant problem, on the assumption that such situations would be viewed as partnerships for business classification purposes even if they are not so regarded for tax purposes. On the other hand, some of these cases may in fact be direct investment situations, so that they should properly be omitted from the portfolio investment figures.

Even though a number of problems would exist in using the SOI data as a supplement to the FPIS, the virtually complete coverage of the top sample strata would produce reliable estimates for this segment of the population. A tabulation based on the SOI sample should be regarded as a preliminary effort which would not define the level of foreign investment in LPIs but could be used to estimate the approximate magnitudes of foreigners' portfolio investment in partnership interests in the United States.

If the Treasury should decide to pursue this effort, subject to the qualifications noted, the project could be undertaken along the following lines.

Identification of Partnerships in FPIS Group

The first step would be to identify the Forms 1065 pertaining to partnerships in the SOI sample with assets of $2 million or more. This could be done on the basis of end-1978 assets (Schedule L, line 13 B) or end-1979 assets (Block F, or Schedule L, line 13 D).

Identification of Foreign Partners

The next step would be to identify partnerships which have foreign partners, by identifying Schedules K-1 attached to Forms 1065 in the sample with assets of $2 million or more which show addresses outside the United States. This would permit a tabulation on the basis of a definition of "foreigner" reasonably consistent with that used in the FPIS. The "foreign"

[1] IRS, 1976 Statistics of Income, Business Income Tax Returns, p. 237.

partners would include, in addition to nonresident aliens, U.S. nationals residing abroad and types of foreign partners other than individuals, such as corporations, fiduciaries, partnerships, and nominees.

Information from Forms 1065

A tentative list of the information to be obtained from Forms 1065 filed by partnerships having foreign partners is shown at the left, below. The uses of the items are shown at the right.

Item	Uses
Name and address of partnership	Mailing list for use in survey or reporting, if necessary.
Block C-Business code number	Line 5a, FPI-1 -Activity code
Block D-Employer identification number	Identification; link with Schedule K-1
Line 1c-Gross receipts less returns and allowances (1979)	Line 13, FPI-1 -Total net sales or operating revenues
Line 26-Ordinary income (loss)	Line 14, FPI-1-Income before taxes
Schedule L :	
Line 13-Total assets B (1978) ____________ D (1979) ____________	Line 10, FPI-1-Total assets Initial sort to eliminate 1065s with assets below $2 million
Line 20-Partner's capital accounts B (1978) D (1979)	Possible analytical use Line 12, FPI-1 -Total net worth
Line 13 minus line 20	Line 11, FPI-1 -Total liabilities
Block I-Is the partnership a limited partnership? Yes______ No_______	Possible use in analysis of final tabulations

Information from Schedules K-1 Pertaining to Foreign Partners

A tentative list of information to be obtained from Schedules K-1 pertaining to foreign partners, and the uses of the items, is shown below.

Item	Uses
Name and address of partner	Mailing list for use in survey or reporting, if necessary.
Partner's identifying number	Possible use in matching with other IRS forms.
Partnership's identifying number	Match with Form 1065
Name of foreign country of partner____________ Foreign country code____	Stub of Schedule A, FPI-1
Block B. Is partner a nonresident alien? Yes___ No ___	Positive B identifies a foreign national residing abroad (column 5, Schedule A, FPI-1)
Block C(i). Is partner a limited partner? Yes___ No ___	Positive C(i) identifies an LPI. Negative C(i) together with Fa identifies a portfolio investment in a GPI. Negative C(i) together with Fb identifies a direct investment.
(ii) If "yes," is partner also a general partner? Yes___ No ___	Significance is not clear.
Block F. Partner's percentage of ownership of capital: a. Less than 10% ___ b. 10% or more ___	
Block H. What type of entity is this partner? a. individual ___ b. corporation___ c. fiduciary ___ d. partnership___ e. nominee ___	Negative B with Ha identifies a US national residing abroad (column 4, Schedule A, FPI-1). Negative B with Hb,c,d or e identifies types of foreigners other than individuals.

Schedule M-Partner's capital account: a. C/A, beg. of year ___ b. Capital contributed during year ___ c. Ordinary income (loss) ___ d. Income not in c ___ e. Losses not in c ___ f. Withdrawals and distributions ___ g. C/A, end of year ___	Provides end-1978 and end-1979 position figures, and 1979 capital contribution, net income or loss, and withdrawals. In balance-of-payments terms, b represents capital inflow, and f represents a combination of earnings distribution and capital outflow which can be distinguished through analysis.

Tabulation of the Information

The objective of the project would be to obtain information from the SOI data files that could "supplement" the FPIS. A supplement to the FPIS could take a number of forms, depending on the amount of detail extracted from Schedules K-1.

The schedules above outlining the data items which could be obtained from Form 1065 and Schedule K-1 would provide, for each partnership with assets of $2 million or more in which there are foreign partners, an approximation to the information reported on Form FPI-1, Part 1, and Schedule A. This would permit a number of tabulations and cross-tabulations which presumably could be related to the tabulation plans for the FPIS itself.

There appear to be two possibilities: (1) the tabulation could be done by the SOI staff on the basis of table plans specified by FPIS; or (2) the tabulation could be done by FPIS using copies of or data from the individual 1065s and K-1s. The choice involves the disclosure rules applicable to the availability of partnership tax return data to the FPIS staff for statistical and analytical purposes, and may also involve a question of timing and resources. The SOI staff has indicated that the process of sample selection will go on through December 1980, that editing will continue through March 1981, and that the file will be perfected in April 1981. Tabulation of the sample data could not begin before April 1981, because the file will not be available until then.

If this timing would present a problem for the FPIS, the possibility of obtaining data from the individual 1065s and K-1s could be explored, with tabulation to be done by FPIS. This does not appear to be a good alternative, however, because the returns from the larger partnerships tend to be late in arriving. This fact, and the fact that the sample selection will not be complete until the end of 1980, make it doubtful that tabulation of data on an earlir schedule than that envisaged by the IRS would be complete enough to be meaningful.

Timing

A detailed listing of the data required by FPIS - "codes and items" in IRS terminology - would have to be provided to the SOI staff as soon as possible, not later than March 31, 1980. If the tabulations are to be done by SOI, the table plans would have to be provided by December 31, 1980.

Cost

No estimate is yet available on the cost of the project. The SOI staff have indicated that extracting and tabulating the FPIS data would not represent a major addition to their projected workload, and that the cost would be reasonable. A concrete cost estimate cannot be obtained from the IRS until the data specifications and table plans are determined.

Conclusion

The use of the SOI partnership sample to develop information on foreigners' portfolio investment in partnership interests in the United States, as outlined above, should produce a set of data which could be viewed as an approximation -- an indication of the nature and order of magnitude of foreigners' portfolio investment in partnership interests in the United States, rather than a set of figures that could confidently be added to the results of the FPIS. The result would probably not be as reliable as a tabulation of reports designed by FPIS and filed by partnerships in which foreigners have an interest, but it should indicate whether the magnitude of such investment is significant and give some information on the industries in which the investment has occurred and the foreign countries which are involved. It might also provide some clues as to an effective approach to further efforts to obtain data on this type of foreign investment, if it should appear necessary to undertake such efforts.

Form **1065** — Department of the Treasury, Internal Revenue Service

U.S. Partnership Return of Income

For calendar year 1979, or fiscal year beginning ...., 1979, and ending ...., 19....

1979

A Principal business activity (see page 12 of Instructions)	Use IRS label. Otherwise please print or type. Name	D Employer identification no.
B Principal product or service (see page 12 of Instructions)	Number and street	E Date business started
C Business code number (see page 12 of Instructions)	City or town, State, and ZIP code	F Enter total assets from Schedule L, line 13, column (D). $

G Check method of accounting: (1) ☐ Cash (2) ☐ Accrual (3) ☐ Other (attach explanation)

H Is this a final return? ☐ Yes ☐ No

IMPORTANT—You must fill in all lines and schedules. If more space is needed, see page 2 of Instructions. Enter any items specially allocated to the partners on Schedule K, line 16, and not on the numbered lines on this page or in Schedules A through J.

Income

1a	Gross receipts or sales $ .... 1b Less returns and allowances $ .... Balance ▶	1c	
2	Cost of goods sold and/or operations (Schedule A, line 34)	2	
3	Gross profit (subtract line 2 from line 1c)	3	
4	Ordinary income (loss) from other partnerships and fiduciaries (attach statement)	4	
5	Nonqualifying dividends	5	
6	Interest	6	
7	Net income (loss) from rents (Schedule H, line 2)	7	
8	Net income (loss) from royalties (attach schedule)	8	
9	Net farm profit (loss) (attach Schedule F (Form 1040))	9	
10	Net gain (loss) (Form 4797, line 11)	10	
11	Other income (attach schedule)	11	
12	TOTAL income (loss) (combine lines 3 through 11)	12	

Deductions

13a	Salaries and wages (other than to partners) $ .... 13b Less Jobs Credit $ .... Balance ▶	13c	
14	Guaranteed payments to partners (see page 4 of Instructions)	14	
15	Rent	15	
16	Interest	16	
17	Taxes	17	
18	Bad debts (see page 5 of Instructions)	18	
19	Repairs	19	
20	Depreciation (Schedule J, line 5)	20	
21	Amortization (attach schedule)	21	
22	Depletion (other than oil and gas, attach schedule—see page 5 of Instructions)	22	
23a	Retirement plans, etc. (see page 5 of Instructions). (Enter number of plans ▶ ....)	23a	
23b	Employee benefit programs (see page 5 of Instructions)	23b	
24	Other deductions (attach schedule)	24	
25	TOTAL deductions (add lines 13c through 24)	25	
26	Ordinary income (loss) (subtract line 25 from line 12)	26	

Schedule A—COST OF GOODS SOLD AND/OR OPERATIONS (See Page 3 of Instructions)

27	Inventory at beginning of year (if different from last year's closing inventory, attach explanation)	27	
28a	Purchases $ .... 28b Less cost of items withdrawn for personal use $ .... Balance ▶	28c	
29	Cost of labor	29	
30	Materials and supplies	30	
31	Other costs (attach schedule)	31	
32	Total of lines 27 through 31	32	
33	Inventory at end of year	33	
34	Cost of goods sold (subtract line 33 from line 32). Enter here and on line 2, above	34	

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Signature of general partner ▶ Date

Paid Preparer's Information

Preparer's signature and date ▶		Check if self-employed ▶ ☐	Preparer's social security no.
Firm's name (or yours, if self-employed) and address ▶		E.I. No. ▶	
		ZIP code ▶	

(144)

Schedule L—BALANCE SHEETS (See Page 10 of Instructions)

ASSETS	Beginning of taxable year (A) Amount	Beginning of taxable year (B) Total	End of taxable year (C) Amount	End of taxable year (D) Total
1 Cash				
2 Trade notes and accounts receivable				
a Less allowance for bad debts				
3 Inventories				
4 Government obligations: a U.S. and instrumentalities				
b State, subdivisions thereof, etc.				
5 Other current assets (attach schedule)				
6 Mortgage and real estate loans				
7 Other investments (attach schedule)				
8 Buildings and other fixed depreciable assets				
a Less accumulated depreciation				
9 Depletable assets				
a Less accumulated depletion				
10 Land (net of any amortization)				
11 Intangible assets (amortizable only)				
a Less accumulated amortization				
12 Other assets (attach schedule)				
13 Total assets				
LIABILITIES AND CAPITAL				
14 Accounts payable				
15 Mortgages, notes, and bonds payable in less than 1 year				
16 Other current liabilities (attach schedule)				
17 All nonrecourse loans (attach schedule)				
18 Mortgages, notes, and bonds payable in 1 year or more				
19 Other liabilities (attach schedule)				
20 Partners' capital accounts				
21 Total liabilities and capital				

Schedule M—RECONCILIATION OF PARTNERS' CAPITAL ACCOUNTS (See Page 11 of Instructions)

(Show reconciliation of each partner's capital account on Schedule K–1, block M)

a. Capital account at beginning of year	b. Capital contributed during year	c. Ordinary income (loss) from page 1, line 25	d. Income not included in column c, plus non-taxable income	e. Losses not included in column c, plus unallowable deductions	f. Withdrawals and distributions	g. Capital account at end of year

Schedule N—COMPUTATION OF NET EARNINGS FROM SELF-EMPLOYMENT (See Page 11 of Instructions)

1 Ordinary income (loss) (Form 1065, page 1, line 26)			1	
2 Guaranteed payments to partners included on Schedule K, lines 1a(1) and 1a(2)	2			
3 Net loss from rental of real estate	3			
4 Net loss from Form 4797 (Form 1065, page 1, line 10)	4			
5 Total (add lines 2, 3, and 4)			5	
6 Add lines 1 and 5. (If line 1 is a loss, reduce line 1 by the amount on line 5)			6	
7 Nonqualifying dividends (Form 1065, page 1, line 5)	7			
8 Interest	8			
9 Net income from rental of real estate	9			
10 Net gain from Form 4797 (Form 1065, page 1, line 10)	10			
11 Total (add lines 7, 8, 9, and 10)			11	
12 Net earnings (loss) from self-employment (subtract line 11 from line 6). Enter on Schedule K, line 9			12	

Additional Information Required

	Yes	No
I Is the partnership a limited partnership (see page 2 of Instructions)?		
J Is this partnership a partner in another partnership?		
K (1) Did you elect to claim amortization (under section 191) or depreciation (under section 167(o)) for a rehabilitated certified historic structure (see page 11 of Instructions)?		
(2) Amortizable basis (see page 11 of Instructions) ▶		
L Will the character of any liabilities in Schedule L (Balance Sheets), other than line 17, change to nonrecourse or become covered by a guarantee or similar arrangement in the future? If "Yes," enter the year(s) and amount(s) of the anticipated changes ▶		
M Has any material regarding the offering of a partnership interest or other security ever been registered or filed with a Federal or State agency or authority? If "Yes," attach a statement giving the name and address of the agency(s)		
N At any time during the tax year, did the partnership have an interest in or a signature or other authority over a bank account, securities account, or other financial account in a foreign country (see page 11 of Instructions)?		
O Was the partnership the grantor of, or transferor to, a foreign trust which existed during the current tax year, whether or not the partnership or any partner has any beneficial interest in it? If "Yes," you may have to file Forms 3520, 3520–A, or 926. (See page 11 of Instructions.)		

SCHEDULE K-1 (Form 1065)
Department of the Treasury
Internal Revenue Service

Partner's Share of Income, Credits, Deductions, etc.—1979
For calendar year 1979 or fiscal year
beginning ...., 1979, and ending ...., 19....
(Complete for each partner—See Instructions on back of Copy C)

Copy A
(File with Form 1065)

Partner's identifying number ▶
Partner's name, address, and ZIP code

Partnership's identifying number ▶
Partnership's name, address, and ZIP code

	Yes	No
A (i) Date(s) partner acquired any partnership interest during the year ▶		
(ii) Did partner have any partnership interest before 1/1/77?		
B Is partner a nonresident alien?		
C (i) Is partner a limited partner (see page 2 of Instructions)?		
(ii) If "Yes," is partner also a general partner?		
D (i) Did partner ever contribute property other than money to the partnership (if "Yes," complete line 21)?		
(ii) Did partner ever receive a distribution other than money from the partnership (if "Yes," complete line 22)?		
(iii) Was any part of the partner's interest ever acquired from another partner?		
E (i) Did partnership interest terminate during the year?		
(ii) Did partnership interest decrease during the year?		

F Enter partner's percentage of:

	(i) Before decrease or termination	(ii) End of year
Profit sharing	%	%
Loss sharing	%	%
Ownership of capital		%

Time devoted to business .... %
G IRS Center where partnership return filed ▶
H What type of entity is this partner? ▶
I Partner's share of liabilities (see page 8 of Instructions):

	(i) Incurred before 1/1/77	(ii) Incurred after 12/31/76
Nonrecourse	$	$
Other	$	$

J Enter total amount of liabilities other than nonrecourse for which the partner is protected against loss through guarantees, stop loss agreements, or similar arrangements of which the partnership has knowledge:
Incurred before 1/1/77 .... $
Incurred after 12/31/76 .... $

K Partner's share of any pre-1976 loss(es) from a section 465(c)(1) activity (i.e. film or video tape, section 1245 property leasing, farm, or oil and gas property) for which there existed a corresponding amount of nonrecourse liability at the end of the year in which loss(es) occurred .... $

M Reconciliation of partner's capital account:

a. Capital account at beginning of year	b. Capital contributed during year	c. Ordinary income (loss) from line 1b	d. Income not included in column c, plus non-taxable income	e. Losses not included in column c, plus unallowable deductions	f. Withdrawals and distributions	g. Capital account at end of year

a. Distributive share item	b. Amount	c. 1040 filers enter col. b amount as shown
1 a Guaranteed payments to partner: (1) Deductible by the partnership		Sch. E, Part III
(2) Capitalized by the partnership		Sch. E, Part III
b Ordinary income (loss)		Sch. E, Part III
2 Additional first-year depreciation		Sch. E, Part III
3 Gross farming or fishing income		Sch. E, Part IV
4 Dividends qualifying for exclusion		Sch. B, Part II, line 3
5 Net short-term capital gain (loss) from transactions entered into: a After 10/31/78		Sch. D, line 2
b Before 11/1/78		Sch. D, line 7
6 Net long-term capital gain (loss) from transactions entered into: a After 10/31/78		Sch. D, line 10
b Before 11/1/78		Sch. D, line 19
7 Net gain (loss) from involuntary conversions due to casualty or theft: a After 10/31/78		Form 4797, line 1
b Before 11/1/78		Form 4797, line 1
8 Other net gain (loss) under section 1231 from transactions entered into: a After 10/31/78		Form 4797, line 4
b Before 11/1/78		Form 4797, line 4
9 Net earnings (loss) from self-employment		Sch. SE, Part I or Part II
10 a Charitable contributions: 50% ...., 30% ...., 20%		Sch. A, line 21 or 22
b Other itemized deductions (attach list)		See Sch. A
11 Expense account allowance		
12 Jobs credit		Form 5884, line 9
13 Taxes paid by regulated investment company		Line 61, add words "from 1065"
14 a Payments for partner to a Keogh Plan (Type of plan ▶........)		Line 26
b Payments for partner to an IRA or Simplified Employee Pension (SEP)		Line 25
15 a Foreign taxes paid (attach schedule)		Form 1116
b Other income, deductions, etc. (attach schedule)		(Enter on applicable lines of your return)
c Oil and gas depletion. (Enter amount (not for partner's use) ▶........)		
16 Specially allocated items (see attached schedule): **a** Short-term capital gain (loss)		Sch. D, line 2
b Long-term capital gain (loss)		Sch. D, line 10
c Ordinary gain (loss)		Form 4797, line 10
d Other		Sch. E, Part III

G. SIA COMMENT ON TREASURY'S FOREIGN PORTFOLIO INVESTMENT SURVEY AND OTHER MATERIAL

SECURITIES INDUSTRY ASSOCIATION
20 Broad Street, New York, N.Y. 10005 (212) 425-2700

December 24, 1980

Mr. John R. Karlik,
Deputy Assistant Secretary
Department of Treasury
Washington, DC 20220

Dear Mr. Karlik:

Nick Rey of Merrill Lynch asked me to review the Treasury Department's Report on foreign portfolio investment. I was disappointed to learn that Mr. Rey did not attend the meeting but spoke to you via telephone instead. I thought it would be helpful if you saw my memo highlighting concerns over the Treasury Department's estimates of foreign holdings of U.S. equities.

I believe the memo speaks for itself. As you can see, my major conclusion is that your figures are too low because of the high turnover rates implied for foreign investors. There is no good explanation of why the turnover rate of foreign investors would be three times greater than that of U.S. institutional investors.

If you wish to discuss my conclusions or request additional data from me, I would be happy to cooperate.

Sincerely,

Jeffrey M. Schaefer
Senior Vice President
and Director of Research

JMS:sng
Enc.
cc: David Bauer
Steven McSpadden

Memorandum

To: Nicholas A. Rey **Date:** December 15, 1980

From: Jeffrey M. Schaefer

Subject: Foreign Portfolio Investment Survey Project

The Treasury report on foreign portfolio investment is well-written and the tables and data are presented clearly. All facts and explanations, including the various methodologies employed, are also presented clearly. Some of the highlights are:

-- At year-end 1978, total foreign portfolio investment in the U.S. amounted to $317.8 billion, almost double the estimated $159 billion owned by foreigners at the end of 1974.

-- Almost half ($147 billion) of the $318 billion was in the form of U.S. government obligations. Of this amount, about 88% was in the form of U.S. Treasury debt obligations of various maturities. The bulk of these securities was held by foreign central banks.

-- Bank private sector liabilities was the second largest component of foreign portfolio investment. Of the $101 billion, 75% was held by foreign private banks, companies and individuals, with another 25% held by foreign official institutions.

-- Foreign portfolio ownership of equity securities amounted to about $48 billion, representing 4.3% of the $1.1 billion of stock issued by companies covered in the Treasury survey. This amount was almost double that reported four years previously.

There are other highlights as well, but I think these are the core of the Treasury's findings, except for this conclusion: "This study uncovered no surprises. Virtually all information presented herein was already well-known to public and private decision-makers. As foreign ownership of U.S. assets grows, additional benchmark surveys would be worthwhile. However, they need not be conducted so frequently as once every five years. A frequency of once every 10 years should be adequate to assure the accuracy of existing estimation techniques."

The Treasury is much too comfortable in stating how accurate their figures are. The figures estimating the value of equities held by foreigners are inconsistent with the current flows of data reported for foreign portfolio investors and the turnover rates these imply. In 1978, gross activity of foreign investors amounted to $37.9 billion. If this is compared to the $47.9 billion estimated as foreign holdings, the turnover rate is 79% for foreign investors, far exceeding the norm for U.S. investors and, more importantly, for U.S. institutions. Presumably, foreign investors represent a combination of institutions and individuals and would have a lower turnover rate than U.S. institutions. The average turnover rate for all U.S. institutions was only 26% in 1978.

The Treasury estimates that foreigners held roughly 4.25% of all U.S. equity securities. The figures on foreign activity are inconsistent with these low levels. SIA estimates that foreign activity comprises 12-14% of the total public volume on the NYSE. Again, this raises some suspicion about the Treasury's estimates of the value of shares held by foreigners, or on the monthly data reported for foreign investors on capital flows.

By the way, the study apparently has a simple mathematical mistake. The report notes that almost $43 billion of stocks was in companies with assets of $1 billion or more and only about $12 billion was invested in smaller companies. These two numbers combined amount to a number greater than the estimated $48 billion reported earlier.

The Treasury minimizes the concern of the public and the Congress in foreign ownership of U.S. companies. Although the proportion of ownership held by foreigners may be small, if foreigners decided to dump a substantial part of their holdings at one time, this could have a significant impact on the markets. The total value of all shares listed on the NYSE is about $1 trillion, while today OPEC has about $250 billion available for investment. This is why we need accurate and current data to fend off any surges in protectionist attitudes that might arise in the Congress barring foreign portfolio investment in this country.

In the Treasury study, they note that the combination of relative supplies of U.S. securities, U.S. tax policy and other factors promote high equity security turnover rates by foreigners. The Treasury uses this argument to indicate that the control of U.S. corporations is not a significant objective of foreign investors. Given their unreasonable estimates of turnover rates, for example, a 91% figure for the first quarter of 1980, most reasonable individuals would reflect on the numbers and say there has to be some question about their validity.

The study notes that a major motivation for foreign investment in stocks is the potential for capital appreciation and increases in future income flows. This conclusion is completely inconsistent with very high figures for turnover rates, and should again give the Treasury reason for caution in being so sanguine about their estimates.

By the way, the study also notes the small amount of private debt held by foreigners due to the inability of Treasury to obtain complete information on foreign held bearer bond issues. Another important factor, of course, which Treasury overlooks, is the withholding tax on interest received by foreign private investors.

In conclusion, I would be reluctant to increase the time span between benchmark surveys and would not go along with their recommendation that they expand the time span between surveys to more than five years.

If I can be of any further assistance, just holler.

JMS

JMS:gl

MISC 34 11/76

OFFICE CORRESPONDENCE

FEDERAL RESERVE BANK
OF NEW YORK

DATE: January 17, 1977

TO: Mr. Fousek

SUBJECT: Saudi Arabian Investments with U.S. Overseas Branches

FROM: F. J. Giletti
Balance of Payments Division

Copies to: Messrs. Feder, Gasser.

CONFIDENTIAL--(F.R.)

Attached, as you requested, is a table showing quarterly changes in U.S. overseas branches' liabilities to Saudi Arabia for the period September 1975 - September 1976. The data were derived from the Board's "Quarterly Report on Foreign Branch Assets and Liabilities", which was initiated in September 1975. Consequently, the geographic disposition of aggregate dollar and foreign currency assets and liabilities of overseas branches is not available for earlier dates. Also included for comparison purposes is a summary of Saudi portfolio investments in the United States during the same period.

A series break exists in the foreign branch data, since branches located in Saudi Arabia only began reporting in March 1976. Specifically, these are two branches of Citibank and they accounted for percent of the total foreign branch liabilities to Saudi Arabia from March to September 1976. Calls were made to the Board to ascertain why this delay in reporting occurred. According to Fred Ruckdeschel at the Board, it would be an imposition to ask Citibank to reconstruct data for the September and December 1976 F.R. 502-S reports, since a previous Board directive stipulated March 1976 as the initial filing date for its Saudi branches.

In using the foreign branch data the following points should be noted:

- It is not possible to identify placements by the Saudi Arabian Monetary Authority (SAMA), or for that matter, to identify claims or liabilities of overseas branches vis-à-vis any official institution per se.
- The data include liabilities to nonbanks, sister branches within the same country, and sister branches in other countries.
- The quarterly reports also do not allow identification of foreign currency or dollar assets, as only an aggregate figure is reported.

Liabilities of Overseas Branches of U.S. Banks
to Saudi Arabia
($ millions)

Located in:	QIV	1976 QI	1976 QII	1976 QIII
United Kingdom				
Offshore 1/				
Selected 15 2/				
Total All Overseas Branches				

1/ Includes Bahamas, Cayman Islands, Panama, Hong Kong, Singapore, Lebanon

2/ Includes Belgium, Luxembourg, France, Germany, Italy, Netherlands, Switzerland, United Kingdom, Japan plus Offshore group.

T. Giletti
Balance of Payments Division
January 14, 1977

Saudi Arabian Portfolio Investments in the U.S.
($ millions)

	1975 QIV	1976 QI	1976 QII	1976 QIII
Total				
Official				
FRBNY				
"Street"				
Private				

T. Giletti
Balance of Payments Division
January 17, 1977

APPENDIX 6.—FARM CREDIT ADMINISTRATION, GOVERNMENT NATIONAL MORTGAGE ASSOCIATION (HUD), AND FEDERAL HOME LOAN BANK BOARD OWNERSHIP IN THEIR RESPECTIVE SECURITIES

Farm Credit Administration

490 L'Enfant Plaza
Suite 4000
Washington, DC 20578
(202) 755-2195

CONGRESSMAN BEN ROSENTHAL
RECEIVED
STAFF ______ DOC # ______
JAN 2 1980
PARA: ______
COMMENTS: ______
FILE CODE: ______

January 2, 1980

Honorable Benjamin S. Rosenthal
House of Representatives
Washington, DC 20515

Dear Mr. Rosenthal:

We are pleased to provide you with information concerning the nature and extent of foreign investments in Farm Credit Administration debt securities pursuant to the subcommittee's request of December 5, 1979. Before addressing the questions as presented by the subcommittee, we are providing the subcommittee with some background comments concerning the role of the Farm Credit Administration.

The Farm Credit Administration (FCA) is an independent agency in the executive branch of the government, responsible for supervising and examining the Farm Credit System. All administrative duties and functions of the FCA are exercised and performed by the Governor. The Farm Credit System is composed of the 12 Federal land banks and the Federal land bank associations, the 12 Federal intermediate credit banks and the production credit associations, and the 13 banks for cooperatives. The banks and associations of the Farm Credit System are federally chartered instrumentalities of the United States charged with the responsibility of furnishing farmers, ranchers, and farmer cooperatives with a sound, adequate, and constructive supply of credit.

Question I--Please describe (1) how FCA debt securities are issued and sold, (2) the differences, if any, in the types of securities, and (3) the records kept showing ownership.

The FCA does not issue any debt securities on its own behalf. The securities sold in the marketplace are the direct obligations of the banks of the Farm Credit System: the 12 Federal land banks, the 12 Federal intermediate credit banks, and the 13 banks for cooperatives. The obligations of the banks are not guaranteed by the United States and do not constitute a debt or obligation of the United States or of any agency or instrumentality thereof. The obligations of the System are classified as "Agency securities" and are eligible investments for the Federal Reserve System, national and state banks, fiduciary and trust funds under U. S. Government jurisdiction, and trust companies, savings banks, and trust funds in various states.

Representatives of the banking system, subject to the approval of the Governor, determine the amount, maturities, rate of interest, and participation by the Farm Credit banks in each issue of joint, consolidated, or Systemwide obligations. The Farm Credit banks, as provided in the Farm Credit Act of 1971, maintain a Fiscal Agency which has the statutory responsibility for the issuance, marketing and handling of the System's debt securities. The Fiscal Agency, located in New York City, manages a selling group of security dealers who sell the System's securities.

The Farm Credit System offers two types of securities--a consolidated Systemwide Federal Farm Credit Bank Note and a Federal Farm Credit Bank Bond. The note is sold daily on a discount basis with maturities from 5 to 270 days. The bond is sold in maturities of 6-month, 9-month, intermediate and longer term (18 months to 20 years). The 6- and 9-month securities are sold monthly while the intermediate and long-term issues are sold from 4 to 8 times a year, respectively. The securities of the Farm Credit System are issued in book-entry form only. There are no registered securities and, therefore, no records of ownership are maintained at a level available to the FCA or the Fiscal Agency.

Question II--Provide the subcommittee with the dollar amount of foreign investment in FCA debt securities at present and for the years 1974 through 1979. We would like this information for each year (1) by country, (2)(a) by private investors and (b) foreign official institutions, and (3) the approximate length of maturity and the type of the securities involved.

The FCA has no records of foreign investments in debt securities of the Farm Credit System. The FCA maintains only general ledger balances for System debt outstanding by issue, by Farm Credit bank, and by Federal Reserve bank and branches for book-entry purposes. No ownership list is maintained by FCA or Fiscal Agency due to bearer form characteristic of the obligations. The Federal Reserve acts as fiscal agent for foreign central banks and the Federal Open Market Committee. From time to time, the Fed places direct orders for Agency securities, including Farm Credit obligations with the Fiscal Agency of the System. To the extent possible, the orders are covered but investor identity is not disclosed by the Fed.

Question III--We would also like to know the names of financial institutions, investment houses, and brokerage firms which routinely sell significant amounts (at least 5 percent) of FCA securities, denoting those which you know or you believe to have made sales for foreign investors.

The FCA does not issue securities and, therefore, has no financial institutions, investment houses, or brokerage firms acting on its behalf. The FCA is purely a supervisory and examining agency.

Question IV--Have there ever been any meetings between any FCA officers or employee (and/or brokers acting on behalf of FCA) and any prospective or actual foreign investor, including any official institutions, monetary funds, quasi-government entities, financial institutions, private parties, et al.

FCA officials have had very few meetings with prospective foreign investors. As the subcommittee knows, FCA, as a supervisory agency, has numerous meetings with foreign credit-type institutions but for the principal purpose of exchanging ideas and providing training for credit related activities. The obligations of the System trading as "Agency securities" have attracted substantial investor interest over the years but without the official touting of the FCA.

FCA officials, in reviewing past calendars for foreign and domestic trips, meetings, and conferences, met domestically with an official of the Saudia Arabian Monetary Agency in 1975 and had overseas meetings with Saudi Arabian officials in 1978 to consult on the improvement of Saudi agricultural lending. FCA presently has a seven-member team in Saudi Arabia on a two-year assignment with the Saudi Agricultural Bank under a contract involving the Saudi Government, the Treasury Department, and the Farm Credit Administration. The Fiscal Agency of the Farm Credit System has completed three foreign trips to Europe and the Middle East. The visits included both potential and existing investors and agricultural cooperative banks. No direct or negotiated sales of securities were made.

Question V--Finally, we would like you to furnish to the subcommittee any and all documents, including studies, analyses, research papers, internal memos, notes, papers, letters, etc., from January 1, 1974 to the present, relating in any way to foreign investment in FCA securities. (This request also encompasses documents relating to any of the subjects and meetings referred to above.)

As a result of the limited meetings with foreign investors, we do not have any studies, analyses, research papers, internal memos, etc., concerning foreign investments in Farm Credit System obligations.

We realize that the above information does not provide much insight into the ownership of the debt of the Farm Credit System. While the FCA encourages the System to develop a broader investor base, we recognize that holders of debt instruments exercise no ownership in the System and have no management control. We have not considered the development of an ownership list to be consistent with the relationship between the issuer and the holder of the debt.

If we can be of further help to the subcommittee, please do not hesitate to call.

Sincerely,

Donald E. Wilkinson

Donald E. Wilkinson
Governor

Farm Credit Administration

490 L'Enfant Plaza
Suite 4000
Washington, DC 20578
(202) 755-2195

RECEIVED
APR 2 19
COMMERCE, CONSUMER AND
MONETARY AFFAIRS SUBCOMMITTEE

CONGRESSMAN BEN ROSENTHAL
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DOC #
REC #
MAR 31 1980
PARA:
COMMENTS:
FILE CODE:

March 27, 1980

Honorable Benjamin S. Rosenthal
House of Representatives
Washington, DC 20515

Dear Mr. Rosenthal:

The following information supplements our January 2, 1980 response to a request concerning foreign investments in Farm Credit bank securities from the Subcommittee on Commerce, Consumer, and Monetary Affairs of the Committee on Government Operations.

The data provided results from an FCA review of information at the Fiscal Agency of the Farm Credit banks as well as personal itineraries of overseas trips of officials within the Farm Credit System.

The information in this response correlates to the questions in the subcommittee's initial request of December 5, 1979. Question I requested how securities of the Farm Credit System were issued, types of securities, and any records kept of ownership. A description of the marketing program was provided in FCA's January 2 letter. Unless the subcommittee has specific questions concerning the marketing program, there is not much that can be provided to broaden an understanding of the marketing system of Farm Credit securities.

Question II requested the total dollar amount of foreign investments in Farm Credit securities both for the present and for the years 1974-79. This information should be provided by country, private investor, foreign official institution, and the approximate length of maturity and the type of security involved.

In a conversation in early February with Mr. McSpadden concerning foreign ownership of Farm Credit securities, FCA staff indicated that there was one fairly reliable method of ascertaining foreign interest. That was through the utilization of the primary market distribution surveys of dealers that the Fiscal Agency receives from its selling group. The Farm Credit System utilizes 170 dealers. On a quarterly basis, these dealers submit primary market distribution reports (sample copy included) to the Fiscal Agency. This is a mandatory reporting requirement for membership in the selling group and has been a requirement since February 1977. The Fiscal Agency does not tabulate or computerize the results of the surveys. These quarterly distribution reports are used by the Fiscal Agency in its annual evaluation of each dealer. Once again, the information received is only on the primary sale of a new issue. There are no records of secondary market activity nor are there any records of ownership kept by parties under FCA supervision.

For the purpose of providing the Subcommittee with information on foreign ownership, it was decided to review the number of dealers that would appear to have potential for primary market distribution to foreign investors, as reflected in the quarterly distribution reports. In reviewing the distribution of Farm Credit securities, there are 48 out of 170 dealers who market approximately 75 percent of Farm Credit securities. The enclosed statement of August 23, 1979, from the Domestic Reports Division of the Federal Reserve Bank of New York, indicates 36 dealers who report their activities in Government securities to the Federal Open Market Committee. Of these 36 dealers, 35 belong to the selling group of the Farm Credit System. Of those 35 dealers, 5 are not included in the 48 dealers who market the bulk of the System securities. In reviewing the quarterly distribution reports of those 5 dealers, no foreign accounts were indicated.

To meet the survey's objective, it was decided to review the remaining 30 primary dealers along with 2 other dealers who had previous foreign investments. This was conducted using the quarterly distribution reports for the periods October through December for the years 1977, 1978, and 1979. In this survey, the quarterly sales of 32 dealers multiplied by 96 reporting periods covering 26 sales of securities resulted in a report on 2,996 issues. Of these 32 dealers, only 11 to 13 reported primary sales to foreign accounts. Actually, for the period in 1979, all 170 quarterly distribution reports were reviewed.

It can also be assumed that in most cases any purchases made in the secondary market by foreigners would be made through these same dealers inasmuch as they are the primary dealers for both Government and Agency securities and maintain markets as such.

The results of the survey show foreign investors purchasing from 0 to 11 percent of a new issue. The longer the maturity, the smaller the participation. The average issue was 5-7 percent.

Also enclosed is a summary listing of sales to Federal Reserve customers between 1974 and 1979. The Fiscal Agency has routinely honored Federal Reserve requests to purchase Farm Credit securities for customer accounts up to a limit of 10 percent of an issue. As shown, the 10-percent limit is rarely reached. Also, the fulfilling of requests hinges on domestic needs to maintain an orderly market offering. The Fed does not disclose the identity of its customers, and sales at the Fiscal Agency are booked as "Fed customers."

In viewing the data, 13 percent owned by foreign investors seems a reasonable number for new issue ownership. Secondary market activity is unknown but would add probably 5-7 percent additional ownership to suggest a 15-20 percent range.

Question III requested the names of financial institutions which routinely sell significant amounts (at least 5 percent) of Farm Credit securities and have foreign participation as well. The enclosed listing of Fed dealers includes the 11-13 dealers who make foreign sales. Only one dealer out of 170 sells over 5 percent of Farm Credit securities. This firm is over 5 percent no more than several other firms are under 5 percent. It is a major domestic wire house with capability to sell large quantities of securities in difficult markets. It is primarily domestic and of the 11-13 dealers indicating foreign sales, it would rank as one of the smaller.

In regard to meetings between System personnel and foreign investors, references to foreign travel were stated in the January 2 reply. Enclosed are itineraries of five foreign trips--one by C. K. Cardwell, Deputy Governor, Office of Supervision, Farm Credit Administration, in November 1978, and four by A. K. Johnson, Fiscal Agent for the Farm Credit banks, in September 1976, September 1977, November 1978, and May 1979. No direct or negotiated sales of Farm Credit securities were ever made as a result of foreign meetings. All securities, except Fed orders, are sold through the selling group.

With respect to Question V concerning documentation of any kind of foreign investments, FCA has no studies, analyses, research papers, internal memoranda, etc., concerning foreign investments. With respect to the Fiscal Agency, FCA staff, upon reviewing the Agency's files, did not locate any correspondence or documentation concerning foreign investors.

In conclusion, the Fiscal Agency of the Farm Credit banks utilizes the selling group to market all Systemwide bonds and discount notes. There have been no foreign or domestic private placements, nor any direct or negotiated sales. Only Federal Reserve customer orders and Open Market Committee reinvestments go to the Federal Reserve, and the identity of the "Fed customers" is not provided. No internal documentation is kept concerning foreign investments other than the quarterly distribution reports of dealers. The same can be said about domestic investors. There is no communication between investors and the Fiscal Agency other than the typical investor questions about the System.

If we can be of further help to the subcommittee, please feel free to call.

Sincerely,

Donald E. Wilkinson

Donald E. Wilkinson
Governor

Enclosures

CARDWELL OVERSEAS TRIP - 1978

November 10-11 - Enroute to Paris, France

November 13 - Caisse Locale
Serge Robert, CNCA
Michel Thevney, International Dept., CNCA

Regionale at Reims
Mr. Lagiurd, CEO

November 14 - U.S. Embassy, Concorde Square
Wayne Sharp, Agricultural Attache
Ed Gordor, Financial Attache

CNCA Headquarters

Bank of France

November 15 - Orion Bank, Limited, London
David Montagu, CEO
Andrew Large, Managing Director
Frank Horack, III (U.S.) - Executive Director
Joel Romines (U.S.) - Associate Director
L. J. Morgan, Associate Director
T. M. Van der Buegel, Executive Director

U.S. Embassy, Grosvenor Square, London
William L. Rodman, Ag Attache

November 16 - Chase Manhattan, London
Matthew Haves, Manager, European Commodity Finance
Patricia E. Brennan, Assistant Manager, ECF
Charles Bryant, U.K. Commodity Finance Division
Robert M. Rummel, Correspondent Banking Relations

London & Continental Bankers, Ltd.
B. D. Campbell, Managing Director
Kraig Klossom (U.S.) - Executive VP
G. H. Hoffman (U.S.) - Managing Director
B.C.W. Jonker, Executive Director Europe
M. J. Gibbs, General Manager, Special Services & Investments

November 17 - Centrale Rabobank, Beneluxlaan, Netherlands
G. J. M. Vlak, Member, Executive Board
G. N. Brands, General Manager
O. E. DeFouw, Area Manager, North America
Fischer, Ag Manager, International Division

CEBECO Handelroad, Rotterdam, Holland
George Van DenBerg - CEO
Henk Morisink - Manager, Grain Division

DeNederlandsche Bank N.V., Amsterdam
M. Der Boer, Chief, Foreign Department Investment & Currency Exchange
T. DeSwann, Assistant to Der Boer

November 19 - Enroute to Frankfort

D. G. Bank, Quanustor, Frankfort, Germany

CEO - Peter Von Harder, Chief Ag and Co-op
Mr. Ahl
Mr. Luxen, North American Representative

Bundesbank - Mr. Gelescke

November 22 - Enroute to Rome

November 23 - Enroute to Riyadh

November 24 - Ted Wahl, Assistant Director for U. S. Mission
Robert Campbell, U. S. Embassy in Riyadh

November 25 - Dave Mulford and staff - SAMA
Leonard Ingrams
Lee Vandeburg

Abdullah Al Amille, Assistant to Dr. Al Turki, Deputy Minister of Finance

November 26 - SAMA - Mr. Abdullatif
Saudi Ag Bank - Mangour and Sturt

U. S. Mission - Sturt, Aubrey, Mission Director Wallace Riley

November 27 - Enroute to London

November 28 - Enroute to home

OVERSEAS TRIPS - 1976 - 1979

A. K. Johnson, Fiscal Agency

PURPOSE

1. To explain the advantages of Farm Credit Securities to present investors and/or prospective investors.
2. To continue Farm Credit Banks program to assist developing countries in organizing and implementing agriculture credit programs.
3. To gather information on how the Farm Credit System might be of service to farmers, ranchers and cooperatives in increasing the exports of food and fiber.

AUGUST 30th - Enroute to London

AUGUST 31st - Lloyds of London

- Bankers Trust
- Edward & Payne Ltd.
- John Bruce & Associates
- Heath Co.

SEPT 1 - Bank of England - John Kurbishon,Chief Advisor to Governor,

- Merrett Ltd.
- Crown Agents

SEPT 3 - London Continental Ltd.

- Tom Petscheck, Managing Director of S.G. Warburg & Co. Ltd.
- Bill Campbell, Managing Director of London Continental Ltd.

SEPT 3 - Enroute to Jeddah Saudi Arabia

SEPT 4 - Visted the Central Bank of Saudi Arabia (S.A.M.A.), visited with officials from the Foreign Invesment department.

SEPT 5 - Enroute to Riyadh Saudi Arabia

SEPT 6 - U. S. Embassy - Edward Gnehm, Jr. American Embassy Liason Officer

- Met John Hummond, Director of the Joint U.S.A. Saudi Arabia Commission.
- Deputy Director of Agricultural Bank Hussein El-Kadi
- Arab Investment Company, Dr. Abdel Hafiez A. El-Rafaie, Project Manager

SEPT 7 - Enroute to Kuwait

SEPT 8 - Central Bank of Kuwait, met with Borge Andersen, Advisor to the Governor

- Kuwait Investment Company, Mr. Hamad Al-Bahr, General Manager
- Industrial Bank of Kuwait
- Governor of the Central Bank and Mr. Sigurd W. Strom, Advisor, Foreign Operations Department
- Stephen Worcester Buck, First Secretary, U.S. Embassy Research Director

SEPT 9 - Enroute to New York

SEPT 6, 1977

- Enroute to London

SEPT 7 - Met with Officers of the Citibank

- Other Investors visted:

  Lloyds of London, Crown Agents, Jason Green

SEPT 8 - Presentation on Farm Credit Securities to Investment Managers of Lloyds Syndicates

NOV 10 & 11 1978

- Other people in the group: C.K. Caldwell,,Deputy Governor, Farm Credit Administration, W.M. Harding, President, Central Bank for Cooperatives, Jon M. Greeneisen, Vice President, Central Bank for Cooperatives enroute to Paris.

NOV 13 - Visited Caisse Nationale de Credit Agricole

NOV 14 - Agricultural Attache at the American Embassy - Wayne Winston Sharp

- Central Bank of France, Jacques Waitzeneger
- Enroute to London

NOV 15 - Citibank - John Vernon

- Orion Bank
- American Embassy - William L. Rodman,

NOV 16, 1978

- LLoyds of London - Colin Thomas, Financial Officer
- London & Continental Bank, B. D. Campbell, Managing Director
- Enroute to Holland

NOV 17, 1978

- Rabobank
- Central Bank for the Netherlands - Mr. DeBoer and DeSwan
- Bank for Cooperatives for the Netherlands -

NOV 18 - Enroute to Germany

NOV 19 - Enroute to Germany

NOV 20 - D & G Bank

- Central Bank Germany, Deputy Director Gleske
- D. R. W. Z. Cooperative - August Kreft

NOV 21 & 22

- Enroute to Riyadh, Saudi Arabia

NOV 24 - Joint USA/Saudi Arabian Commission

NOV 25 - Saudi Arabian Monetary Authority - met with investment advisors and officials of the Investment Department

NOV 26 - Conferences with officials of the USA/Saudia Arabian Commission

NOV 27 & 28 - En Route to New York

MAY 4, 5 & 6	- En Route to Tokyo, Japan
MAY 7	- Bank of America
	- Central Bank of Japan -- Deputy Director, Yoshiaki Toda (others on the trip -- Malcolm Harding, President of Central Bank, Jon Greeneisen, Vice President of Central Bank, Burgee Amdahl, President, St. Paul Bank for Cooperatives)
	- Dudley G. Williams, Agricultural Attaché - American Embassy
MAY 8	- Met with top officals of the Norinchukin Bank.
MAY 9	- Central Union of Agricultural Cooperatives
	- ZEN-NOH, the National Federal of Agricultural Cooperative Associations
MAY 10	- Field Trip to a regional cooperative and a local cooperative under the auspices of the officials of the Norinchukin Bank.
MAY 11	- Mr. Imamura, Director General, Economic Affairs Bureau, Ministry of Agriculture, Forestry and Fisheries.
MAY 12 & 13	- En Route to Hong Kong
MAY 14	- Bank of America
	- Orion Pacific Limited
MAY 15	- Hong Kong Shanghai Banking Corporation
	- D.G. Capital Company, Ltd.
MAY 16	- En Route to Manila
MAY 17	- Tours of the Central Bank
	- Asian Development Bank
MAY 18	- Phillipine National Bank
	- Citicorp Investment
MAY 19	- En Route to New York

LIST OF THE GOVERNMENT SECURITIES DEALERS REPORTING TO THE DOMESTIC REPORTS DIVISION OF THE FEDERAL RESERVE BANK OF NEW YORK

Bache Halsey Stuart Shields Inc.
Bank of America NT & SA
Bankers Trust Company
A.G. Becker Incorporated
~~Blyth Eastman Dillon Capital Markets, Incorporated~~
Briggs, Schaedle & Co., Inc.
Carroll McEntee & McGinley Incorporated
The Chase Manhattan Bank, N.A.
Chemical Bank
Citibank, N.A.
Continental Illinois National Bank
and Trust Company of Chicago
Crocker National Bank
Discount Corporation of New York
Donaldson Lufkin & Jenrette Securities Corporation
The First Boston Corporation
First National Bank of Chicago
First Pennco Securities, Inc.
Goldman, Sachs & Co.
Harris Trust and Savings Bank
E.F. Hutton & Company, Inc.
Kidder, Peabody & Co., Incorporated
Aubrey G. Lanston & Co., Inc.
Lehman Government Securities Incorporated
Merrill Lynch Government Securities Inc.
Morgan Guaranty Trust Company of New York
Morgan Stanley & Co., Inc.
The Northern Trust Company
Nuveen Government Securities, Inc.
Paine, Webber, Jackson & Curtis Incorporated - BLYTH
Wm. E. Pollock & Co., Inc.
Chas. E. Quincey & Co.
Salomon Brothers
Second District Securities Co., Inc.
Smith Barney, Harris Upham & Co., Incorporated
Stuart Brothers N.Y. Hanseatic Division
United California Bank
Dean Witter Reynolds Incorporated.

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Note: This list has been compiled and made available for statistical purposes only and has no significance with respect to other relationships between dealers and the Federal Reserve Bank of New York. Qualification for the reporting list is based on the achievement and maintenance of reasonable standards of activity.

Domestic Reports Division
Federal Reserve Bank of New York
August 23, 1979

FEDERAL FARM CREDIT BANKS CONSOLIDATED SYSTEMWIDE BONDS

PAR AMOUNT	ISSUE DATE	MATURITY DATE	RATE	FED CUST
$532,000,000	9/1/77	9/1/82	7.20%	$25,000,000
$430,000,000	9/1/77	9/5/89	7.75%	-0-
$679,000,000	3/1/78	3/1/83	8.05%	$25,000,000
$653,900,000	9/5/78	4/1/82	8.45%	-0-
$1,117,800,000	1/2/79	7/2/79	10.70%	$5,000,000
$1,167,400,000	1/2/79	10/1/79	10.80%	$104,000,000
$400,000,000	1/2/79	9/1/82	9.65%	-0-
$640,050,000	1/22/79	7/20/81	10.00%	$50,000,000
$420,050,000	1/22/79	1/23/84	9.50%	-0-
$1,328,000,000	2/1/79	8/1/79	10.50%	$2,000,000
$877,000,000	2/1/79	11/1/79	10.60%	$3,000,000
$1,398,000,000	3/1/79	9/4/79	10.40%	$5,000,000
$922,000,000	3/1/79	12/3/79	10.45%	$90,000,000
$1,251,100,000	4/2/79	10/1/79	10.25%	$55,000,000
$1,053,000,000	4/2/79	1/2/80	10.25%	$50,000,000
$575,000,000	4/23/79	10/20/80	9.90%	$40,000,000
$862,600,000	4/23/79	4/23/84	9.45%	-0-
$1,598,900,000	5/1/79	11/1/79	10.10%	$5,000,000
$1,232,000,000	5/1/79	2/4/80	10.10%	$4,000,000
$1,086,000,000	6/4/79	12/3/79	10.25%	$5,000,000
$806,000,000	6/4/79	3/3/80	10.20%	$4,000,000
$1,167,500,000	7/2/79	1/2/80	9.60%	$5,000,000
$1,079,000,000	7/2/79	4/1/80	9.60%	$55,000,000
$652,500,000	7/23/79	1/20/82	8.90%	$25,000,000
$1,128,000,000	7/23/79	1/23/84	9.00%	-0-
$661,500,000	7/23/79	7/22/91	9.10%	-0-
$1,673,000,000	8/1/79	2/4/80	10.30%	$100,000,000
$1,220,000,000	8/1/79	5/1/80	10.20%	$16,000,000
$1,313,000,000	9/4/79	3/3/80	10.65%	$28,000,000
$1,380,000,000	9/4/79	6/2/80	10.60%	$7,000,000
$1,419,500,000	10/1/79	4/1/80	11.40%	$79,000,000
$1,172,000,000	10/1/79	7/1/80	11.30%	$75,000,000
$749,000,000	10/1/79	6/4/84	9.70%	-0-
$541,500,000	10/23/79	4/20/83	10.90%	-0-
$630,500,000	10/23/79	10/20/86	10.75%	-0-
$414,000,000	10/23/79	10/23/89	10.60%	-0-
$1,921,000,000	11/1/79	5/1/80	14.40%	-0-
$1,429,000,000	11/1/79	8/4/80	14.35%	$4,000,000
$1,617,000,000	12/3/79	6/2/80	12.30%	$50,000,000
$982,000,000	12/3/79	9/2/80	12.25%	$5,000,000
$1,855,000,000	1/2/80	7/1/80	13.15%	$5,000,000
$1,182,000,000	1/2/80	10/1/80	12.80%	$54,000,000
$433,000,000	1/2/80	12/3/84	10.65%	-0-
$755,500,000	1/21/80	10/20/82	10.95%	$75,000,000
$817,500,000	1/21/80	1/21/85	10.90%	$80,000,000
$438,000,000	1/21/80	1/22/90	10.95%	-0-

86-722 O - 82 -52

FEDERAL LAND BANKS

PAR AMOUNT	ISSUE DATE	MATURITY DATE	RATE	FED CUST
$360,000,000	1/21/74	7/20/76	7.05%	-0-
$300,000,000	1/21/74	1/22/79	7.10%	-0-
$389,000,000	2/20/74	7/23/79	7.15%	-0-
$300,000,000	4/22/74	7/21/75	8.30%	-0-
$400,000,000	4/22/74	4/20/76	8 1/4%	-0-
$565,000,000	4/22/74	4/20/77	8 1/4%	$20,000,000
$650,000,000	7/22/74	1/20/76	9.20%	-0-
$350,000,000	7/22/74	7/20/78	9.15%	-0-
$265,200,000	7/22/74	7/20/81	9.10%	-0-
$545,600,000	10/21/74	1/23/78	8.70%	-0-
$400,000,000	10/21/74	10/20/80	8.70%	-0-
$713,400,000	1/20/75	4/20/78	7.60%	-0-
$400,000,000	1/20/75	1/20/82	7.80%	-0-
$750,100,000	4/21/75	1/20/77	7.45%	$50,000,000
$300,000,000	4/21/75	4/20/82	8.15%	-0-
$390,500,000	6/23/75	7/22/85	8.10%	-0-
$650,000,000	7/21/75	10/20/76	7.20%	$50,000,000
$464,100,000	7/21/75	1/20/83	8.20%	-0-
$650,000,000	10/20/75	4/23/79	8.55%	-0-
$434,900,000	10/20/75	10/21/85	8.80%	-0-
$400,000,000	1/20/76	10/20/77	6.60%	-0-
$600,000,000	1/20/76	4/21/80	7.35%	-0-
$420,000,000	1/20/76	1/20/88	7.85%	-0-
$536,600,000	4/20/76	7/20/77	6.25%	$53,000,000
$600,000,000	4/20/76	10/20/81	7.45%	$60,000,000
$350,000,000	4/20/76	4/22/91	7.95%	-0-
$600,000,000	7/20/76	10/20/77	6.70%	$62,000,000
$416,200,000	7/20/76	10/21/85	7.95%	-0-
$450,000,000	10/20/76	1/23/78	6.10%	$45,000,000
$858,200,000	10/20/76	1/20/81	7.10%	$35,000,000
$350,000,000	10/20/76	10/21/96	7.95%	-0-
$700,000,000	1/20/77	4/20/81	6.20%	$70,000,000
$453,400,000	1/20/77	1/20/97	7.35%	-0-
$500,000,000	4/20/77	1/22/79	6.05%	$50,000,000
$547,300,000	4/20/77	1/20/83	7.20%	$55,000,000
$350,000,000	4/20/77	4/20/87	7.60%	-0-
$668,800,000	7/20/77	10/23/79	6.15%	$65,000,000
$600,000,000	7/20/77	1/20/82	6.65%	$60,000,000
$400,000,000	7/20/77	7/20/87	7.25%	-0-
$1,000,000,000	10/20/77	10/19/78	6.80%	$85,000,000
$699,500,000	10/20/77	10/20/83	7.35%	$60,000,000
$925,000,000	1/23/78	7/23/79	7.50%	$107,000,000
$449,800,000	1/23/78	1/22/90	8.20%	-0-
$600,000,000	4/20/78	1/21/80	7.75%	$70,000,000
$600,100,000	4/20/78	10/20/82	8.00%	-0-
$565,000,000	7/20/78	4/21/80	8.60%	-0-
$565,000,000	7/20/78	7/20/82	8.70%	-0-
$924,300,000	10/19/78	7/21/80	8.85%	$10,000,000
$786,800,000	10/19/78	7/20/83	8.65%	-0-

FEDERAL INTERMEDIATE CREDIT BANKS

PAR AMOUNT	ISSUE DATE	MATURITY DATE	RATE	FED CUST
$560,900,000	1/2/74	10/1/74	7.95%	-0-
$405,900,000	1/2/74	1/3/78	7.10%	-0-
$753,500,000	2/4/74	11/4/74	8.00%	-0-
$784,500,000	3/4/74	12/2/74	7.15%	-0-
$608,000,000	4/1/74	1/2/75	8.15%	$10,000,000
$674,000,000	5/1/74	2/3/75	8.80%	-0-
$796,000,000	6/3/74	3/3/75	9.00%	-0-
$811,000,000	7/1/74	4/1/75	9 1/4%	-0-
$320,800,000	7/1/74	4/4/77	8.70%	-0-
$766,000,000	8/1/74	5/1/75	9.45%	-0-
$713,500,000	9/3/74	6/2/75	9.80%	-0-
$769,000,000	10/1/74	7/1/75	9.60%	-0-
$713,000,000	11/4/74	8/4/75	8.45%	-0-
$768,200,000	12/2/74	9/2/75	8.05%	-0-
$457,500,000	1/2/75	10/1/75	7.35%	-0-
$410,200,000	1/2/75	1/2/79	7.40%	-0-
$754,000,000	2/3/75	11/3/75	7.05%	-0-
$897,000,000	3/3/75	12/1/75	6.15%	$10,000,000
$1,078,500,000	4/1/75	1/5/76	6.05%	$75,000,000
$909,000,000	5/1/75	2/2/76	6.60%	$100,000,000
$839,500,000	6/2/75	3/1/76	6.15%	$75,000,000
$738,500,000	7/1/75	4/1/76	5.80%	$50,000,000
$531,000,000	7/1/75	1/2/80	7.40%	-0-
$887,500,000	8/4/75	5/3/76	7.00%	$15,000,000
$725,200,000	9/2/75	6/1/76	7.60%	$80,000,000
$438,500,000	10/1/75	7/1/76	7.70%	$75,000,000
$640,000,000	11/3/75	8/2/76	6.90%	$100,000,000
$713,500,000	12/1/75	9/1/76	6.20%	$100,000,000
$897,700,000	1/5/76	10/4/76	6.55%	$100,000,000
$432,400,000	1/5/76	1/5/81	7.90%	$25,000,000
$962,000,000	2/2/76	11/1/76	5.65%	$100,000,000
$1,037,500,000	3/1/76	12/1/76	5.80%	$100,000,000
$753,500,000	4/1/76	1/3/77	6.10%	$75,000,000
$360,500,000	4/1/76	4/1/86	7.95%	-0-
$1,044,500,000	5/3/76	2/1/77	5.60%	$100,000,000
$946,200,000	6/1/76	3/1/77	6.25%	$95,000,000
$789,000,000	7/1/76	4/4/77	6.50%	$80,000,000
$717,000,000	8/2/76	5/2/77	6.10%	$72,000,000
$770,000,000	9/1/76	6/1/77	5.85%	$77,000,000
$849,700,000	10/4/76	7/5/77	5.80%	$85,000,000
$921,000,000	11/1/76	8/1/77	5.35%	$92,000,000
$864,500,000	12/1/76	9/1/77	5.35%	$87,000,000
$659,500,000	1/3/77	10/3/77	4.90%	$66,000,000
$565,500,000	1/3/77	1/5/87	6.95%	-0-
$971,500,000	2/1/77	11/1/77	5.45%	$100,000,000
$1,066,000,000	3/1/77	12/1/77	5.35%	$107,000,000
$860,200,000	4/4/77	1/3/78	5.35%	$86,000,000
$461,600,000	4/4/77	4/1/82	7.00%	$46,000,000
$891,000,000	5/2/77	2/1/78	5.15%	$89,000,000
$921,000,000	6/1/77	3/1/78	5.80%	$92,000,000
$972,000,000	7/5/77	4/3/78	5.75%	$100,000,000
$989,000,000	8/1/77	5/1/78	5 7/8%	$100,000,000

FEDERAL INTERMEDIATE CREDIT BANKS

PAR AMOUNT	ISSUE DATE	MATURITY DATE	RATE	FED CUST
$901,500,000	9/1/77	6/1/78	6.45%	$87,000,000
$714,000,000	10/3/77	7/3/78	6.40%	$71,000,000
$889,000,000	11/1/77	8/1/78	7.05%	$90,000,000
$849,000,000	12/1/77	9/5/78	6.90%	$85,000,000
$871,000,000	1/3/78	10/2/78	6.90%	$87,000,000
$323,300,000	1/3/78	7/1/80	7.30%	$32,000,000
$744,000,000	2/1/78	11/1/78	7.20%	$50,000,000
$806,000,000	3/1/78	12/4/78	7.35%	$75,000,000
$1,045,000,000	4/3/78	1/2/79	7.15%	$50,000,000
$1,034,000,000	5/1/78	2/1/79	7.30%	$25,000,000
$1,002,000,000	6/1/78	3/1/79	7.95%	$87,000,000
$858,000,000	7/3/78	4/2/79	8.20%	$20,000,000
$1,007,000,000	8/1/78	5/1/79	8.45%	-0-
$777,000,000	9/5/78	6/4/79	8.45%	$78,000,000
$845,000,000	10/2/78	7/2/79	8.70%	$5,000,000
$830,000,000	11/1/78	8/1/79	9.40%	-0-
$731,000,000	12/4/78	9/4/79	10.00%	$5,000,000

BANKS FOR COOPERATIVES

PAR AMOUNT	ISSUE DATE	MATURITY DATE	RATE	FED CUST
$462,200,000	1/2/74	7/1/74	7.95%	-0-
$556,000,000	2/4/74	8/1/74	8.15%	-0-
$342,500,000	3/4/74	9/3/74	7.15%	-0-
$251,200,000	4/1/74	10/1/74	8.20%	-0-
$211,700,000	5/1/74	11/4/74	8.65%	-0-
$351,400,000	6/3/74	12/2/74	8.90%	-0-
$398,200,000	7/1/74	1/2/75	9 1/4%	-0-
$575,500,000	8/1/74	2/3/75	9.45%	-0-
$514,600,000	9/3/74	3/3/75	9.85%	-0-
$340,700,000	10/1/74	4/1/75	9.55%	-0-
$676,500,000	11/4/74	5/1/75	8.55%	-0-
$511,300,000	12/2/74	6/2/75	8.05%	-0-
$200,900,000	12/2/74	10/1/79	8.00%	-0-
$439,700,000	1/2/75	7/1/75	7.40%	-0-
$474,000,000	2/3/75	8/4/75	7.05%	-0-
$391,600,000	3/3/75	9/2/75	6.05%	-0-
$313,700,000	4/1/75	10/1/75	5.85%	-0-
$322,500,000	5/1/75	11/3/75	6.15%	-0-
$428,300,000	6/2/75	12/1/75	5.80%	-0-
$423,700,000	7/1/75	1/5/76	5.65%	-0-
$475,000,000	8/4/75	2/2/76	6.80%	-0-
$505,600,000	9/2/75	3/1/76	7.40%	-0-
$434,000,000	10/1/75	4/1/76	7.50%	-0-
$214,700,000	10/1/75	10/2/78	8.55%	-0-
$568,500,000	11/3/75	5/3/76	6.75%	-0-
$448,800,000	12/1/75	6/1/76	6.00%	-0-
$588,700,000	1/5/76	7/1/76	5.35%	-0-
$399,000,000	2/2/76	8/2/76	5.35%	$5,000,000
$200,000,000	2/2/76	1/2/86	7.75%	-0-
$421,100,000	3/1/76	9/1/76	5.45%	$5,000,000
$499,600,000	4/1/76	10/4/76	5.80%	-0-
$409,500,000	5/3/76	11/1/76	5.20%	-0-
$410,800,000	6/1/76	12/1/76	5.80%	$2,000,000
$614,700,000	7/1/76	1/3/77	6.15%	-0-
$565,000,000	8/2/76	2/1/77	5.80%	-0-
$436,100,000	9/1/76	3/1/77	5.65%	-0-
$569,600,000	10/4/76	4/4/77	5.60%	-0-
$578,500,000	11/1/76	5/2/77	5.25%	-0-
$582,300,000	12/1/76	6/1/77	5.20%	-0-
$745,200,000	1/3/77	7/5/77	4.75%	-0-
$761,000,000	2/1/77	8/1/77	5.20%	-0-
$669,100,000	3/1/77	9/1/77	5.10%	-0-
$742,100,000	4/4/77	10/3/77	5.10%	-0-
$364,000,000	4/4/77	4/1/81	6.85%	-0-
$428,500,000	5/2/77	11/1/77	4.95%	-0-
$465,300,000	6/1/77	12/1/77	5.50%	-0-
$415,200,000	7/5/77	1/3/78	5.50%	-0-
$518,000,000	8/1/77	2/1/78	5.70%	-0-
$419,100,000	9/1/77	3/1/78	6.25%	-0-
$633,100,000	10/3/77	4/3/78	6.30%	-0-
$597,500,000	11/1/77	5/1/78	6.90%	-0-
$701,300,000	12/1/77	6/1/78	6.75%	-0-

BANKS FOR COOPERATIVES

PAR AMOUNT	ISSUE DATE	MATURITY DATE	RATE	FED CUST
$646,200,000	1/3/78	7/3/78	6.75%	-0-
$463,000,000	2/1/78	8/1/78	7.05%	-0-
$624,000,000	3/1/78	9/5/78	7.20%	-0-
$730,500,000	4/3/78	10/2/78	6.95%	-0-
$626,500,000	5/1/78	11/1/78	7.00%	-0-
$488,300,000	6/1/78	12/4/78	7.65%	-0-
$470,200,000	7/3/78	1/2/79	7.90%	-0-
$475,000,000	8/1/78	2/1/79	8.25%	-0-
$463,000,000	9/5/78	3/1/79	8.20%	-0-
$878,100,000	10/2/78	4/2/79	8.60%	$5,000,000
$959,900,000	11/1/78	5/1/79	9.40%	$5,000,000
$670,000,000	12/4/78	6/4/79	10.00%	$4,000,000

Farm Credit Banks
Quarterly Primary Market Distribution Report

Period______________thru______________

Dealer's Name ____________________

Authorized Signature ____________________

Security (FLB, FICB, BC)												
Coupon												
Dated												
Maturity												
Regular Allotment												
Specials												
Pre-trading Purchases												
Total												
Sales												
Net Position												

Sales (omit secondary sales)	No. Trans.	Amts. (000)	No. Trans.	Amts. (000)	No. Trans.	Amts. (000)	No. Trans.	Amts. (000)	No. Trans.	Amts. (000)	No. Trans.	Amts. (000)	No. Trans.	Amts. (000)	No. Trans.	Amts. (000)	No. Trans.	Amts. (000)	No. Trans.	Amts. (000)	No. Trans.	Amts. (000)	No. Trans
Commercial Banks:																							
Trust																							
Portfolio																							
Investment Advisory																							
Trading																							
State and Local Gov'ts																							
Savings and Loan Assoc																							
Savings Banks																							
Insurance Companies																							
Credit Unions																							
Corporations																							
Pension Funds																							
Foreign Accounts																							
Fraternal, Charitable and Educational																							
Individuals																							
Other Dealers																							
Miscellaneous																							
Total																							
Comments on Geographical Distribution by States (Abbrev.)																							

Fiscal Agency
90 William Street
New York, New York 10038
Telephone (212) 943-2303

Peter J. Carney, Fiscal Agent

FARM CREDIT BANKS

CONGRESSMAN BEN ROSENTHAL
RECEIVED
STAFF DOC #
REC #
AUG 22 1980
PARA:
COMMENTS:
FILE CODE:

August 19, 1980

The Honorable Benjamin S. Rosenthal
U.S. HOUSE OF REPRESENTATIVES
Washington, D.C. 20515

Dear Mr. Rosenthal:

This letter is written in support of H.R. 7553 relating to Exemptions From U.S. Tax For Interest Paid To Foreign Persons.

I have long supported the removal of the withholding tax on interest income paid to foreign investors as it strongly puts our securities at a disadvantage to those issued in the Eurobond market. Even though a tax credit may result from such withholdings, the European or foreign investor still loses the use of funds for the period of time that the tax is withheld until the credit is received. This makes Eurobond issuances more competitive to foreign investors than the obligations issued in our domestic capital market. The removal of this tax would aid capital formation in the United States as it would make the yields on domestic obligations comparable and competitive with those in the Eurobond market and thus attract foreign long-term investments.

The removal of this tax would also keep the United States as the center for the domestic and international money and capital markets. This is a position long held by the United States but is being challenged now by the emergence and growth of the Eurobond market. The removal of this tax would make the obligations issued domestically directly competitive with those issued abroad.

The removal of the tax would also help repatriate U.S. dollars held abroad. The Eurodollar market today is so large nobody really knows the exact size of it, however, if we could issue obligations which would be competitive with the Eurobond market, investors would most certainly buy United States obligations because of their security in lieu of foreign issued obligations. The dollars paid for these obligations would come directly into our own economy.

In reading the testimony of the Honorable Donald C. Lubick on behalf of the United States Treasury, it appears that, at most, only $33 million in revenue would be lost if this Bill were passed. I would not consider this a significant loss of revenue with the resultant repatriation of U.S. dollars and capital formation in the United States financed through the Euro market.

Obviously, there would be concerns that abuses could occur from such legislation. The potential for such abuses could be limited by proper documentation within the Bill to eliminate or prohibit the possibility of abuses by domestic investors.

As the Fiscal Agent for the Farm Credit Banks, I am strongly interested in raising money to finance agriculture in the United States at the least possible cost to the American farmer. I have always been a very strong believer that some day the money and capital markets would be one, big international market with the United States as the dominent factor in this market. The Farm Credit System has just under $60 billion in securities outstanding, the proceeds of which have been used to finance agriculture in the United States. During 1979 the Farm Credit System raised $10.4 billion in net new money to finance agriculture in our country. Through August 4 of this year we have raised $7,963.4 million through the domestic money and capital markets to lend to farmers and support agriculture. Needless to say, any addition to the sources of funds that we make available to farmers would be a significant help to agriculture in this country.

I strongly support this Bill and will make every effort possible to ask others to support and seek its passage. I also commend you for sponsoring such a Bill, as I think it would be a tremendous asset to this country as it would provide a new source of funds at competitive rates to aid the capital formation in our country as well as in the repatriation of U.S. dollars.

Sincerely,

Peter J. Carney
Fiscal Agent

THE OPERATIONS OF FEDERAL AGENCIES IN MONITORING, REPORTING ON, AND ANALYZING FOREIGN INVESTMENTS IN THE UNITED STATES (Part 2—OPEC Investment in the United States)

[EXCERPT FROM:]

HEARINGS

BEFORE A

SUBCOMMITTEE OF THE

COMMITTEE ON

GOVERNMENT OPERATIONS

HOUSE OF REPRESENTATIVES

NINETY-SIXTH CONGRESS

FIRST SESSION

JULY 16, 17, 18, AND 26, 1979

Printed for the use of the Committee on Government Operations

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52-414 O WASHINGTON : 1979

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
GOVERNMENT NATIONAL MORTGAGE ASSOCIATION
WASHINGTON, D.C. 20410

June 20, 1979

Honorable Benjamin S. Rosenthal
Chairman, Subcommittee on Commerce,
Consumer, and Monetary Affairs
Committee on Government Operations
House of Representatives
Washington, D.C. 20515

Dear Mr. Rosenthal:

I am replying to your letter of June 8, 1979 to Mr. John H. Dalton, former President of the Government National Mortgage Association (GNMA), concerning foreign investments in GNMA guaranteed securities.

There are approximately 150,000 individual GNMA certificates outstanding. Their aggregate original principal balance exceeds $75 billion. A data system, in the form of a "central registry" of certificate ownership, was begun during 1978. That central registry system is maintained for GNMA by Chemical Bank, in New York City, under a contract with us. Prior to 1978 there was no central data system which contained detailed information on the ownership of GNMA securities.

We recently were required to report information similar to that which you request to the U.S. Department of the Treasury as part of their Foreign Portfolio Investment Project. That effort required a computer review of all GNMA certificate ownership records as of the end of calendar year 1978. Chemical Bank conducted the review for us, and was reimbursed on the basis of actual costs. That analysis revealed only 15 foreign holders of GNMA guaranteed securities as of the end of 1978. The aggregate original principal amount of those securities was $770,000. Enclosed are copies of the forms we submitted to the Treasury Department. They show the amounts held, by country of residence. You will note that in all but one instance the certificates are owned by U.S. nationals living abroad. In no instance is the country of residence an OPEC country.

Your letter requests data for each year 1974 through 1978, and as of the present. As I've indicated, the information you request was only maintained by GNMA beginning in 1978, so that it cannot be supplied for the earlier years. Because the data for 1978 that we are supplying is so recent, and displays so few foreign holders, we hope you will not need a more current listing. It could only be obtained through another complete review by Chemical Bank of the entire central registry data file, at a significant cost to GNMA.

As you are likely aware, there may be substantial investments by foreigners in GNMA guaranteed securities through nominee accounts. About 16 percent of the dollar value of GNMA securities is held in nominee names. We have no way of knowing who the true owners of such investments are. However, we understand that the Treasury Department is developing such information through surveys of banks as part of the Foreign Portfolio Investment Project.

I trust I have responded to your request, and hope you find the information that we've supplied useful. Please do not hesitate to contact me if we can be of further assistance.

Sincerely,

Fred Taylor

Fred Taylor
Executive Vice President

Enclosures

FPI-1 SCHEDULE B – BREAKDOWN OF FOREIGN OWNERSHIP (OTHER THAN BY "FOREIGN PARENT") IN REPORTER'S DEBT SECURITIES, BY COUNTRY

OMB No. 48-S-78002 Approval Expires May 1980

8 Control number (same as Item 1) C-

EI number (same as Item 2) 52 - 0 88 3 31 9

CUSIP number (from Part III) N/A

Issue code number (from Part III) 2 1

Name of reporter (Same as Item 3) Government National Mortgage Association

Describe issue (from Part III) Pool # 01366

NOTE: IF ISSUE IS DENOMINATED IN A FOREIGN CURRENCY *DO NOT* CONVERT INTO U.S. DOLLARS

9

Foreign Countries (1)	Country Codes (See Annex A of General Instructions for list of codes) (2)	Total Columns (4) through (9) (3)	FACE AMOUNT OF ISSUE HELD BY FOREIGN PERSONS AS OF 12/31/78 — INDIVIDUALS RESIDING ABROAD: U.S. nationals residing abroad (4)	Foreign nationals residing abroad (5)	ALL OTHER FOREIGN PERSONS: Official institutions (6)	Banks, brokers and nominees (7)	Investment cos., insurance cos., pension funds & other employee benefit funds or trusts (8)	Other (9)
Total – all countries (same as item 21b FPI-1) (enter total on first page only)	9999-6	50,000.00		50,000.00				
Canada	2999-8							
France	1080-4							
Germany (West)	1100-2							
Netherlands	1210-6							
Switzerland	1268-8							
United Kingdom	1300-6							
Other Countries—List Panama	3188-7	50,000.00		50,000.00				

OMB No. 48-S-78002 Approval Expires May 1980

FPI-1 SCHEDULE B – BREAKDOWN OF FOREIGN OWNERSHIP (OTHER THAN BY "FOREIGN PARENT") IN REPORTER'S DEBT SECURITIES, BY COUNTRY

DE 8

Control number (same as Item 1) C-

EI number (same as Item 2) 52-0883319

CUSIP number (from Part III) NA

Issue code number (from Part III) 21

Name of reporter (Same as Item 3)

Government National Mortgage Association

Describe issue (from Part III)

Pool #01387

NOTE: IF ISSUE IS DENOMINATED IN A FOREIGN CURRENCY *DO NOT* CONVERT INTO U.S. DOLLARS

DE 9

Foreign Countries (1)	Country Codes (See Annex A of General Instructions for list of codes) (2)	FACE AMOUNT OF ISSUE HELD BY FOREIGN PERSONS AS OF 12/31/78						
		Total Columns (4) through (9) (3)	INDIVIDUALS RESIDING ABROAD		ALL OTHER FOREIGN PERSONS			
			U.S. nationals residing abroad (4)	Foreign nationals residing abroad (5)	Official institutions (6)	Banks, brokers and nominees (7)	Investment cos., insurance cos., pension funds & other employee benefit funds or trusts (8)	Other (9)
Total – all countries (same as item 21b FPI-1) (enter total on first page only)	9999-6	40,000.00	40,000.00					
Canada	2999-8							
France	1080-4							
Germany (West)	1100-2	40,000.00	40,000.00					
Netherlands	1210-6							
Switzerland	1268-8							
United Kingdom	1300-5							
Other Countries–List								

OMB No. 48-S-78002 Approval Expires May 1980

FPI-1 SCHEDULE B – BREAKDOWN OF FOREIGN OWNERSHIP (OTHER THAN BY "FOREIGN PARENT") IN REPORTER'S DEBT SECURITIES, BY COUNTRY

Control number (same as Item 1) C-

EI number (same as Item 2) 52-0883319

CUSIP number (from Part III) NA

Issue code number (from Part III) 21

Name of reporter (Same as Item 3): Government National Mortgage Association

Describe issue (from Part III) Pool # 02329

NOTE: IF ISSUE IS DENOMINATED IN A FOREIGN CURRENCY *DO NOT* CONVERT INTO U.S. DOLLARS

Foreign Countries (1)	Country Codes (See Annex A of General Instructions for list of codes) (2)	FACE AMOUNT OF ISSUE HELD BY FOREIGN PERSONS AS OF 12/31/78						
			INDIVIDUALS RESIDING ABROAD		ALL OTHER FOREIGN PERSONS			
		Total Columns (4) through (9) (3)	U.S. nationals residing abroad (4)	Foreign nationals residing abroad (5)	Official institutions (6)	Banks, brokers and nominees (7)	Investment cos., insurance cos., pension funds & other employee benefit funds or trusts (8)	Other (9)
Total – all countries (same as item 21b FPI-1), (enter total on first page only)	9999-6	35,000.00	35,000.00					
Canada	2999-8							
France	1080-4							
Germany (West)	1100-2							
Netherlands	1210-6							
Switzerland	1268-8							
United Kingdom	1300-5							
Other Countries—List Mexico	3170-4	35,000.00	35,000.00					

FPI-1 SCHEDULE B — BREAKDOWN OF FOREIGN OWNERSHIP (OTHER THAN BY "FOREIGN PARENT") IN REPORTER'S DEBT SECURITIES, BY COUNTRY

OMB No. 48-S-78002 Approval Expires May

DE 8

Control number (same as Item 1) C-

EI number (same as Item 2) 5 2 - 08 8 33 1 9

CUSIP number (from Part III) NA

Issue code number (from Part III) 2 1

Name of reporter (Same as Item 3)

Government National Mortgage Association

Describe issue (from Part III)

Pool # 02336

NOTE: IF ISSUE IS DENOMINATED IN A FOREIGN CURRENCY *DO NOT* CONVERT INTO U.S. DOLLARS

DE 9

Foreign Countries (1)	Country Codes (See Annex A of General Instructions for list of codes) (2)	Total Columns (4) through (9) (3)	FACE AMOUNT OF ISSUE HELD BY FOREIGN PERSONS AS OF 12/31/78 — INDIVIDUALS RESIDING ABROAD: U.S. nationals residing abroad (4)	Foreign nationals residing abroad (5)	ALL OTHER FOREIGN PERSONS: Official institutions (6)	Banks, brokers and nominees (7)	Investment cos., insurance cos., pension funds & other employee benefit funds or trusts (8)	Other (9)
Total — all countries (same as item 21b FPI-1) (enter total on first page only)	9999-6	25,000.00	25,000.00					
Canada	2999-8							
France	1080-4							
Germany (West)	1100-2							
Netherlands	1210-6							
Switzerland	1268-8							
United Kingdom	1300-5							
Other Countries—List Austria	1018-9	25,000.00	25,000.00					

FPI-1 SCHEDULE B – BREAKDOWN OF FOREIGN OWNERSHIP (OTHER THAN BY "FOREIGN PARENT") IN REPORTER'S DEBT SECURITIES, BY COUNTRY

OMB No. 48-S-78002 Approval Expires May 1980

DE 8 Control number (same as Item 1) C-

EI number (same as Item 2) 5 2 – 08 8 33 1 9

CUSIP number (from Part III) NA

Issue code number (from Part III) 2 1

Name of reporter (Same as Item 3)
Government National Mortgage Association

Describe issue (from Part III)
Pool # 03416

NOTE: IF ISSUE IS DENOMINATED IN A FOREIGN CURRENCY *DO NOT* CONVERT INTO U.S. DOLLARS

DE 9

Foreign Countries (1)	Country Codes (See Annex A of General Instructions for list of codes) (2)	FACE AMOUNT OF ISSUE HELD BY FOREIGN PERSONS AS OF 12/31/78: Total Columns (4) through (9) (3)	INDIVIDUALS RESIDING ABROAD: U.S. nationals residing abroad (4)	INDIVIDUALS RESIDING ABROAD: Foreign nationals residing abroad (5)	ALL OTHER FOREIGN PERSONS: Official institutions (6)	ALL OTHER FOREIGN PERSONS: Banks, brokers and nominees (7)	ALL OTHER FOREIGN PERSONS: Investment cos., insurance cos., pension funds & other employee benefit funds or trusts (8)	ALL OTHER FOREIGN PERSONS: Other (9)
Total – all countries (same as item 21b FPI-1) (enter total on first page only)	9999-6	25,000.00	25,000.00					
Canada	2999-8							
France	1080-4	25,000.00	25,000.00					
Germany (West)	1100-2							
Netherlands	1210-6							
Switzerland	1268-8							
United Kingdom	1300-5							
Other Countries–List								

OMB No. 48-S-78002 Approval Expires May 1980

FPI-1 SCHEDULE B – BREAKDOWN OF FOREIGN OWNERSHIP (OTHER THAN BY "FOREIGN PARENT") IN REPORTER'S DEBT SECURITIES, BY COUNTRY

Control number (same as Item 1) C-

EI number (same as Item 2) 52-0188331 19

CUSIP number (from Part III) NA

Issue code number (from Part III) 21

Name of reporter (Same as Item 3)
Government National Mortgage Association

Describe issue (from Part III)
Pool # 03499

NOTE: IF ISSUE IS DENOMINATED IN A FOREIGN CURRENCY *DO NOT* CONVERT INTO U.S. DOLLARS

Foreign Countries (1)	Country Codes (See Annex A of General Instructions for list of codes) (2)	Total Columns (4) through (9) (3)	FACE AMOUNT OF ISSUE HELD BY FOREIGN PERSONS AS OF 12/31/78 — INDIVIDUALS RESIDING ABROAD: U.S. nationals residing abroad (4)	Foreign nationals residing abroad (5)	ALL OTHER FOREIGN PERSONS: Official institutions (6)	Banks, brokers and nominees (7)	Investment cos., insurance cos., pension funds & other employee benefit funds or trusts (8)	Other (9)
Total – all countries (same as item 21b FPI-1) (enter total on first page only)	9999-6	25,000.00	25,000.00					
Canada	2999-8							
France	1080-4							
Germany (West)	1100-2							
Netherlands	1210-6							
Switzerland	1268-8							
United Kingdom	1300-5							
Other Countries–List Japan	4260-9	25,000.00	25,000.00					

OMB No. 48-S-78002 Approval Expires May 1980

FPI-1 SCHEDULE B – BREAKDOWN OF FOREIGN OWNERSHIP (OTHER THAN BY "FOREIGN PARENT") IN REPORTER'S DEBT SECURITIES, BY COUNTRY

DE 8

Control number (same as Item 1) C-

EI number (same as Item 2) 52-0883319

CUSIP number (from Part III) NA

Issue code number (from Part III) 21

Name of reporter (Same as Item 3) Government National Mortgage Association

Describe issue (from Part III) Pool # 04230

NOTE: IF ISSUE IS DENOMINATED IN A FOREIGN CURRENCY *DO NOT* CONVERT INTO U.S. DOLLARS

DE 9

Foreign Countries (1)	Country Codes (See Annex A of General Instructions for list of codes) (2)	FACE AMOUNT OF ISSUE HELD BY FOREIGN PERSONS AS OF 12/31/78						
		Total Columns (4) through (9) (3)	INDIVIDUALS RESIDING ABROAD		ALL OTHER FOREIGN PERSONS			
			U.S. nationals residing abroad (4)	Foreign nationals residing abroad (5)	Official institutions (6)	Banks, brokers and nominees (7)	Investment cos., insurance cos., pension funds & other employee benefit funds or trusts (8)	Other (9)
Total – all countries (same as item 21b FPI-1) (enter total on first page only)	9999-6	50,000.00	50,000.00					
Canada	2999-8							
France	1080-4							
Germany (West)	1100-2							
Netherlands	1210-6							
Switzerland	1268-8							
United Kingdom	1300-5							
Other Countries–List Mexico	3170-4	50,000.00	50,000.00					

OMB No. 48-S-78002 Approval Expires May 1980

FPI-1 SCHEDULE B – BREAKDOWN OF FOREIGN OWNERSHIP (OTHER THAN BY "FOREIGN PARENT") IN REPORTER'S DEBT SECURITIES, BY COUNTRY

DE 8

Control number (same as Item 1) C-

EI number (same as Item 2) 5 2 - 0 88 3 3 10

CUSIP number (from Part III) NA

Issue code number (from Part III) 2 1

Name of reporter (Same as Item 3)
Government National Mortgage Association

Describe issue (from Part III)
Pool # 05808

NOTE: IF ISSUE IS DENOMINATED IN A FOREIGN CURRENCY *DO NOT* CONVERT INTO U.S. DOLLARS

DE 9

Foreign Countries	Country Codes (See Annex A of General Instructions for list of codes)	FACE AMOUNT OF ISSUE HELD BY FOREIGN PERSONS AS OF 12/31/78						
		Total Columns (4) through (9)	INDIVIDUALS RESIDING ABROAD		ALL OTHER FOREIGN PERSONS			
			U.S. nationals residing abroad	Foreign nationals residing abroad	Official institutions	Banks, brokers and nominees	Investment cos., insurance cos., pension funds & other employee benefit funds or trusts	Other
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Total – all countries (same as item 21b FPI-1) (enter total on first page only)	9999-6	25,000.00	25,000.00					
Canada	2999-8							
France	1080-4							
Germany (West)	1100-2							
Netherlands	1210-6							
Switzerland	1268-8							
United Kingdom	1300-5							
Other Countries–List Mexico	3170-4	25,000.00	25,000.00					

FPI-1 SCHEDULE B – BREAKDOWN OF FOREIGN OWNERSHIP (OTHER THAN BY "FOREIGN PARENT") IN REPORTER'S DEBT SECURITIES, BY COUNTRY

OMB No. 48-S-78002 Approval Expires May 1980

DE 8 Control number (same as Item 1) C-

EI number (same as Item 2) 52-0883319

CUSIP number (from Part III) NA

Issue code number (from Part III) 21

Name of reporter (Same as Item 3)
Government National Mortgage Association

Describe issue (from Part III)
Pool # 06116

NOTE: IF ISSUE IS DENOMINATED IN A FOREIGN CURRENCY *DO NOT* CONVERT INTO U.S. DOLLARS

DE 9

Foreign Countries (1)	Country Codes (See Annex A of General Instructions for list of codes) (2)	FACE AMOUNT OF ISSUE HELD BY FOREIGN PERSONS AS OF 12/31/78						
			INDIVIDUALS RESIDING ABROAD		ALL OTHER FOREIGN PERSONS			
		Total Columns (4) through (9) (3)	U.S. nationals residing abroad (4)	Foreign nationals residing abroad (5)	Official institutions (6)	Banks, brokers and nominees (7)	Investment cos., insurance cos., pension funds & other employee benefit funds or trusts (8)	Other (9)
Total – all countries (same as item 21b FPI-1) (enter total on first page only)	9999-6	25,000.00	25,000.00					
Canada	2999-8							
France	1080-4							
Germany (West)	1100-2							
Netherlands	1210-6							
Switzerland	1268-8							
United Kingdom	1300-5							
Other Countries—List Austria	1018-9	25,000.00	25,000.00					

OMB No. 48-S-78002 Approval Expires May 1980

FPI-1 SCHEDULE B – BREAKDOWN OF FOREIGN OWNERSHIP (OTHER THAN BY "FOREIGN PARENT") IN REPORTER'S DEBT SECURITIES, BY COUNTRY

Control number (same as Item 1) C-

EI number (same as Item 2) 52-0883319

CUSIP number (from Part III) NA

Issue code number (from Part III) 21

Name of reporter (Same as Item 3) Government National Mortgage Association

Describe issue (from Part III) Pool # 06209

NOTE: IF ISSUE IS DENOMINATED IN A FOREIGN CURRENCY *DO NOT* CONVERT INTO U.S. DOLLARS

Foreign Countries	Country Codes (See Annex A of General Instructions for list of codes)	FACE AMOUNT OF ISSUE HELD BY FOREIGN PERSONS AS OF 12/31/78						
			INDIVIDUALS RESIDING ABROAD		ALL OTHER FOREIGN PERSONS			
		Total Columns (4) through (9)	U.S. nationals residing abroad	Foreign nationals residing abroad	Official institutions	Banks, brokers and nominees	Investment cos., insurance cos., pension funds & other employee benefit funds or trusts	Other
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Total – all countries (same as item 21b FPI-1) (enter total on first page only)	9999-6	25,000.00	25,000.00					
Canada	2000-8							
France	1080-4							
Germany (West)	1100-2							
Netherlands	1210-6							
Switzerland	1268-8							
United Kingdom	1300-5							
Other Countries–List Austria	1018-9	25,000.00	25,000.00					

OMB No. 48-S-78002 Approval Expires May 1980

FPI-1 SCHEDULE B – BREAKDOWN OF FOREIGN OWNERSHIP (OTHER THAN BY "FOREIGN PARENT") IN REPORTER'S DEBT SECURITIES, BY COUNTRY

DE 8

Control number (same as Item 1) C-

EI number (same as Item 2) 52-0883319

CUSIP number (from Part III) NA

Issue code number (from Part III) 21

Name of reporter (Same as Item 3)
Government National Mortgage Association

Describe issue (from Part III)
Pool # 07989

NOTE: IF ISSUE IS DENOMINATED IN A FOREIGN CURRENCY *DO NOT* CONVERT INTO U.S. DOLLARS

DE 9

Foreign Countries (1)	Country Codes (See Annex A of General Instructions for list of codes) (2)	FACE AMOUNT OF ISSUE HELD BY FOREIGN PERSONS AS OF 12/31/78						
		Total Columns (4) through (9) (3)	INDIVIDUALS RESIDING ABROAD		ALL OTHER FOREIGN PERSONS			
			U.S. nationals residing abroad (4)	Foreign nationals residing abroad (5)	Official institutions (6)	Banks, brokers and nominees (7)	Investment cos., insurance cos., pension funds & other employee benefit funds or trusts (8)	Other (9)
Total – all countries (same as item 21b FPI-1) (enter total on first page only)	9999-6	100,000.00	100,000.00					
Canada	2999-8	100,000.00	100,000.00					
France	1080-4							
Germany (West)	1100-2							
Netherlands	1210-6							
Switzerland	1268-8							
United Kingdom	1300-5							
Other Countries–List								

OMB No. 48-S-72022 Approval Expires May 1980

FPI-1 SCHEDULE 8 – BREAKDOWN OF FOREIGN OWNERSHIP (OTHER THAN BY "FOREIGN PARENT") IN REPORTER'S DEBT SECURITIES, BY COUNTRY

08

Control number (same as Item 1) C-

EI number (same as Item 2) 52-0188319

CUSIP number (from Part III) NA

Issue code number (from Part III) 21

Name of reporter (Same as Item 3)

Government National Mortgage Association

Describe issue (from Part III)

Pool # 10401

NOTE: IF ISSUE IS DENOMINATED IN A FOREIGN CURRENCY *DO NOT* CONVERT INTO U.S. DOLLARS

09

Foreign Countries (1)	Country Codes (See Annex A of General Instructions for list of codes) (2)	Total Columns (4) through (9) (3)	FACE AMOUNT OF ISSUE HELD BY FOREIGN PERSONS AS OF 12/31/78 — INDIVIDUALS RESIDING ABROAD: U.S. nationals residing abroad (4)	Foreign nationals residing abroad (5)	ALL OTHER FOREIGN PERSONS: Official institutions (6)	Banks, brokers and nominees (7)	Investment cos., insurance cos., pension funds & other employee benefit funds or trusts (8)	Other (9)
Total – all countries (same as item 21b FPI-1) (enter total on first page only)	9999-6	100,000.00	100,000.00					
Canada	2999-8	100,000.00	100,000.00					
France	1080-4							
Germany (West)	1100-2							
Netherlands	1210-6							
Switzerland	1268-8							
United Kingdom	1300-5							
Other Countries – List								

OMB No. 48-S-78002 Approval Expires May 1980

FPI-1 SCHEDULE B – BREAKDOWN OF FOREIGN OWNERSHIP (OTHER THAN BY "FOREIGN PARENT") IN REPORTER'S DEBT SECURITIES, BY COUNTRY

OE 8

Control number (same as item 1) C-

EI number (same as item 2) 52 - 08 8 33 1 9

CUSIP number (from Part III) NA

Issue code number (from Part III) 2 1

Name of reporter (Same as Item 3)

Government National Mortgage Association

Describe issue (from Part III)

Pool # 21209

NOTE: IF ISSUE IS DENOMINATED IN A FOREIGN CURRENCY *DO NOT* CONVERT INTO U.S. DOLLARS

OE 9

Foreign Countries	Country Codes (See Annex A of General Instructions for list of codes)	FACE AMOUNT OF ISSUE HELD BY FOREIGN PERSONS AS OF 12/31/78						
			INDIVIDUALS RESIDING ABROAD		ALL OTHER FOREIGN PERSONS			
		Total Columns (4) through (9)	U.S. nationals residing abroad	Foreign nationals residing abroad	Official institutions	Banks, brokers and nominees	Investment cos., insurance cos., pension funds & other employee benefit funds or trusts	Other
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Total – all countries (same as item 21b FPI-1) (enter total on first page only)	9999-6	100,000.00	100,000.00					
Canada	2999-8							
France	1080-4							
Germany (West)	1100-2							
Netherlands	1210-6							
Switzerland	1268-8							
United Kingdom	1300-5	100,000.00	100,000.00					
Other Countries–List								

OMB No. 48-S-78002 Approval Expires May 1980

FPI-1 SCHEDULE B – BREAKDOWN OF FOREIGN OWNERSHIP (OTHER THAN BY "FOREIGN PARENT") IN REPORTER'S DEBT SECURITIES, BY COUNTRY

Control number (same as Item 1) C-

EI number (same as Item 2) 52-0883310

CUSIP number (from Part III) NA

Issue code number (from Part III) 21

Name of reporter (Same as Item 3) Government National Mortgage Association

Describe issue (from Part III) Pool # 24363

NOTE: IF ISSUE IS DENOMINATED IN A FOREIGN CURRENCY *DO NOT* CONVERT INTO U.S. DOLLARS

Foreign Countries	Country Codes (See Annex A of General Instructions for list of codes)	FACE AMOUNT OF ISSUE HELD BY FOREIGN PERSONS AS OF 12/31/78						
		Total Columns (4) through (9)	INDIVIDUALS RESIDING ABROAD		ALL OTHER FOREIGN PERSONS			
			U.S. nationals residing abroad	Foreign nationals residing abroad	Official institutions	Banks, brokers and nominees	Investment cos., insurance cos., pension funds & other employee benefit funds or trusts	Other
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Total – all countries (same as item 21b FPI-1) (enter total on first page only)	9999-6	75,000.00	75,000.00					
Canada	2999-8							
France	1080-4							
Germany (West)	1100-2							
Netherlands	1210-6							
Switzerland	1268-8							
United Kingdom	1300-5							
Other Countries–List Mexico	3170-4	75,000.00	75,000.00					

OMB No. 48-S-78002 Approval Expires May 1980

FPI-1 SCHEDULE B – BREAKDOWN OF FOREIGN OWNERSHIP (OTHER THAN BY "FOREIGN PARENT") IN REPORTER'S DEBT SECURITIES, BY COUNTRY

Control number (same as Item 1) C-

EI number (same as Item 2) 52 - 08 8 33 1 9

CUSIP number (from Part III) NA

Issue code number (from Part III) 2 1

Name of reporter Same as Item 2)
Government National Mortgage Association

Describe issue (from Part III)
Pool # 28276

NOTE: IF ISSUE IS DENOMINATED IN A FOREIGN CURRENCY *DO NOT* CONVERT INTO U.S. DOLLARS

Foreign Countries (1)	Country Codes (See Annex A of General Instructions for list of codes) (2)	Face Amount of Issue Held by Foreign Persons as of 12/31/78: Total Columns (4) through (9) (3)	Individuals Residing Abroad: U.S. nationals residing abroad (4)	Individuals Residing Abroad: Foreign nationals residing abroad (5)	All Other Foreign Persons: Official institutions (6)	All Other Foreign Persons: Banks, brokers and nominees (7)	All Other Foreign Persons: Investment cos., insurance cos., pension funds & other employee benefit funds or trusts (8)	All Other Foreign Persons: Other (9)
Total – all countries (same as item 21b FPI-1) (enter total on first page only)	9999-6	70,000.00	70,000.00					
Canada	2999-8							
France	1080-4							
Germany (West)	1100-2							
Netherlands	1210-6							
Switzerland	1268-8							
United Kingdom	1300-5							
Other Countries–List Mexico	3170-4	70,000.00	70,000.00					

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
GOVERNMENT NATIONAL MORTGAGE ASSOCIATION
WASHINGTON, D.C. 20410

12 JUL 1979

CONGRE[illegible] R[illegible] STAFF REC # 1979 PARA: COMMENTS FILE CODE:

Honorable Benjamin S. Rosenthal
Chairman, Subcommittee on Commerce
Consumer, and Monetary Affairs
Committee on Government Operations
House of Representatives
Washington, D.C. 20515

Dear Mr. Rosenthal:

I am writing to follow up on a telephone conversation I had with Mr. Stephen R. McSpadden on July 11, 1979 concerning foreign ownership of GNMA guaranteed securities.

As was indicated in my letter to you of June 20, 1979, at the end of 1978 there were $770,000 in outstanding GNMA securities held by investors with foreign addresses. This amount represents an exceedingly small proportion of the total amount of GNMA securities outstanding. That total amount exceeds $60 billion.

Mr. McSpadden indicated to me in the course of our telephone conversation that it would be helpful to your Subcommittee if GNMA could arrange for the regular collection of data on foreign holdings of GNMA securities. We have determined that this will be possible. All information on ownership of GNMA securities is maintained on our behalf by Chemical Bank in New York City, which serves as our transfer agent and central registry. At present the ownership records are coded for statistical purposes based on 17 different categories of investor groups. Foreign holders are not one of the separately identified groups, but instead data reflecting foreign ownership are included in such other categories as individuals, corporations, or a miscellaneous "other" category. We are arranging, however, to have Chemical Bank in the future establish an 18th category of holders which will represent foreign ownership. Chemical Bank will begin to produce data on this foreign ownership category in approximately two months.

The foreign ownership category of investors is being defined for our purposes to exclude ownership of GNMA securities by U.S. citizens living abroad. You may recall that of the $770,000 of foreign holdings of GNMA securities that we reported to you, most were held by U.S. citizens living abroad. Such holdings will be excluded from the statistical system we are now establishing. Please let us know if this is inconsistent with your wishes.

As our new data become available, it will be possible to obtain special printouts of just the foreign holdings using any breakout you may desire. This would include breakouts by OPEC and non-OPEC ownership, and by foreign official ownership and foreign private ownership.

I sincerely hope we have responded to your needs.

Sincerely,

Fred Taylor

Fred Taylor
Executive Vice President

Federal Home Loan Bank Board

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

JAY JANIS
Chairman

OCT 9 1979

The Honorable Benjamin S. Rosenthal
Chairman
Subcommittee on Commerce, Consumer
and Monetary Affairs
Committee on Government Operations
U. S. House of Representatives
Washington, D. C. 20515

Dear Mr. Chairman:

This is in response to your letter of August 28, 1979, referring to the Subcommittee's investigation into the operations and activities of Federal agencies in monitoring, reporting on, and analyzing foreign investment in the United States. Your letter requests certain information concerning the nature and extent of such investment by both OPEC and non-OPEC countries in debt securities of the Federal Home Loan Banks and the Federal Home Loan Mortgage Corporation.

The information requested in your letter and our replies are as follows:

I.

Q. Please describe how FHLB and FHLMC debt securities are issued and sold, the difference, if any, in the types of securities, and the records kept showing ownership.

A. The Federal Home Loan Banks issue two types of securities, consolidated bonds and consolidated discount notes. These are debt instruments and do not constitute ownership. The coupon bearing bonds typically have been issued in maturities ranging from one to twenty years, although most have maturities within eight years. Until November 1977 bonds could be purchased in definitive form, that is, a paper security with coupons attached (also called a bearer bond) as well as in book-entry form. In late 1977, we ceased issuing definitive bonds; all new issues are in book-entry form only. The book-entry system is managed by the Federal Reserve Banks. They maintain records on behalf of their member commercial banks for each book-entry issue outstanding from the Treasury and the federally sponsored agencies. If one of their members purchases a bond, the member's account for that specific issue is increased by the amount purchased and the member's cash account is decreased to reflect the amount paid. No paper is transferred; the entry is made on the "books" of the Federal Reserve Bank. This is all done by computers and was developed to eliminate the immense amount of paperwork and risk assumed in moving definitive securities from one bondholder to another. In effect, all book-entry securities exist only on the computers of the Federal Reserve System. The Bank Board does not know the owners of these bonds, only the amount held by each Federal Reserve Bank or Branch.

FHLB discount notes are still issued in definitive form only through the Federal Reserve Bank of New York. They have maturities ranging from 30 to 360 days. No ownership records for either discount notes or definitive bonds are maintained since the bearer has full rights to the interest and principal unless the instrument has been reported stolen or lost.

The Mortgage Corporation currently utilizes two basic types of securities to finance purchase activities. These are the Mortgage Participation Certificate (PC) and the Guaranteed Mortgage Certificate (GMC). Two additional securities represent minor sources of funds: GNMA guaranteed bonds and capital debentures. None of these securities constitutes an ownership interest in FHLMC.

The PC represents an undivided interest in a pool of residential conventional mortgages. PCs are sold on a weekly basis through fourteen securities dealers and the Corporation's own marketing staff. The securities are issued in fully registered certificate form only. The Mortgage Corporation maintains the registration information and makes payments to the holders. In addition, Manufacturers Hanover Trust acts as transfer agent. Remittances containing interest and principal are mailed monthly to the registered holders.

The GMC also represents an undivided interest in a pool of residential conventional mortgages. GMCs are typically issued quarterly through the Office of Finance of the Federal Home Loan Banks. The securities are issued in fully registered certificate form only. The Federal Reserve Bank of New York acts as registrar and paying agent. Interest is paid by check semi-annually and principal is passed through annually in minimum scheduled amounts.

In the past, but not since 1973, the Mortgage Corporation raised funds by issuing bonds guaranteed by the Government National Mortgage Association. These securities were issued only in registered form through the New York Federal Reserve Bank.

Last December, the Mortgage Corporation introduced a new security, the Mortgage Corporation Capital Debenture. These are subordinated debt which are issued and sold in the same way as FHLB bonds, in book-entry form only. Thus far there has been only one debenture issue.

Several factors concerning FHLMC securites may cause them to be relatively unattractive to foreign investors vis a vis other available investments. These reasons are described below.

First, FHLMC is a new entity. It was chartered in 1970, and significant securities issuances did not begin until 1977. With this brief a track record, FHLMC may lack sufficient market presence to attract foreign investors.

Second, FHLMC's primary securities (PCs and GMCs) have 30 year maturities. During the few conversations FHLMC representatives have had with foreign investors, we learned that their primary interest is in securities with terms of less than 5 years.

Third, the tax status of FHLMC for foreign investors is unclear. Unless exempted, foreign investors holding United States securities are subject to 30 percent withholding tax on the income from such securities. While investors in some countries holding some types of securities are wholly or partially exempt from this tax treatment as a result of treaties with the United States, neither PCs nor GMCs is clearly covered by any of these treaties. The practical market effect of the 30 percent withholding tax is to substantially discourage investment in those securities which are not exempt. Further, PCs (which are FHLMC's major security) are constructed so as to produce significant income tax advantages for thrift institutions chartered within the United States (principally savings and loan associations and mutual savings banks). These tax advantages are unavailable to foreign investors.

Foreign investors with whom former Chairman McKinney met during the trip referred to in Part IV advised that there would be interest in FHLMC securities if they could be exempted from the 30 percent withholding tax and a shorter maturity were available.

The Mortgage Corporation issues three securities which are registered: PCs, GMCs and GNMA guaranteed bonds. Although one might expect ownership of registered securities to be easily determinable, this is not the case. Approximately 25 percent of FHLMC's registered securities are registered in the name of their actual owners and only a few of these investors have foreign addresses.

The remaining 75 percent of FHLMC's registered securities are held in nominee or "street" names. The registration lists indicate the name of the organization holding the security in safekeeping, but do not contain the name of the actual owner. Most nominee or street names are associated with commercial banks or dealer firms who hold these securities for their customers. When a security is held in street name, the identity of the actual owner is not available to the Federal Home Loan Bank Board.

The Federal Home Loan Banks and Mortgage Corporation securities are initially sold by a number of securities dealers and dealer banks across the country. These dealers comprise the primary selling groups for our securities. In effect, we sell the securities to the dealers and they in turn sell them to their customers, some of whom are probably foreign investors. We do not know to whom our securities are resold.

The only data we receive after a primary sale is a report from each member of the selling group showing the distribution of each issue of securities by general type of customer and geographic location. Furthermore, any owner of our securities may sell them at any time to whomever they wish. We are not informed of these later secondary market sales so it is impossible for us to know at any time the current ownership of our securities, except those owners of registered securities who have chosen to list them in their own names.

The Federal Reserve Bank of New York acts as our agent in issuing these securities and in paying interest. We request them either to create a book-entry issue on their computer and then provide instructions for its distribution throughout the Federal Reserve wire system or to issue paper securities and receive payment from dealers and dealer banks who send messengers to physically pick them up.

II.

Q. We would like to know the dollar amount of foreign investment in FHLB and FHLMC securities for each of the years 1974 through 1978 and as of the present time. We would like this information for each year and the present (a) by country, (b) (1) by private investors and (2) foreign official institutional investors, and (c) the approximate length of maturity of the securities involved.

To the extent that not all of the information above exists, please provide as much information as you can. If there are gaps in the records, we would like you to respond to this question: Has anyone within the Federal Home Loan Bank System ever been advised of the possible or actual approximate dollar amount of investments in FHLB or FHLMC securities by any foreign country at any time and, if so, what amounts were given and what countries were involved?

A. At the time we sell a new issue of FHLB securities, foreign customers may purchase bonds in one of two ways. They may go directly to a member of our selling group. Or, some special foreign customers (central banks, etc.) may request the Federal Reserve Bank of New York to place an order directly with us. The Federal Reserve Bank of New York encourages foreign central banks to purchase agency securities through their trading desk since this provides one means of observing foreign activity in Treasury and Agency securities. We do not require either a dealer or the Federal Reserve Bank of

New York to indicate the name of the customer. Special foreign investors may also request the Federal Reserve Bank of New York to place orders for FHLMC GMCs and capital debentures, but none has done so.

We attempt to meet these requests, subject to our own judgment and the orderly process of a sale. After each of our bond sales we require our dealers to submit a report showing the distribution of our securities by customer type and geographic location. "Foreign accounts" is one category. A summary of the total "foreign" sales for each Federal Home Loan Bank issue since 1974 is attached as Appendix A, as well as the amounts which have been sold through the New York Federal Reserve Bank, some of which are presumably for foreign customers.

We have also included in Appendix B summaries of the distribution reports submitted to us for each FHLB bond issue from November, 1977 through May, 1979. These show the types of investors to whom initial sales were made by the members of our selling group and also reflects the secondary market trading which occurred during the interim period between the primary sale date and the issue date, called the "when issued" or "WI" period.

You may find it helpful to refer to the Treasury's "Survey of Ownership" published monthly in the Treasury Bulletin. It provides a rough breakdown of current ownership of Treasury and agency securities by type of owner. The data is collected by Treasury and does not originate from our records.

To answer your last question in Part II: No one within the Federal Home Loan Bank System has ever been advised of the possible or actual approximate dollar amount of investments in FHLB or FHLMC securities by any foreign country at any time.

III

Q. We would also like to know the names of financial institutions, investment houses, and brokerage firms which routinely sell significant amounts (at least five percent) of FHLB or FHLMC securities, denoting those which you know or you suspect to have made sales to foreign investors.

III.

A. A large number of dealer firms and dealer banks trade our securities. It is reasonable to assume that nearly every securities dealer in the country has dealt in FHLB or FHLMC securities at some time. We sell our securities initially through firms who are members of our various selling groups. We do not know when issues are traded in the secondary market and therefore are not able to indicate which firms sell at least five percent. For example, after an initial sale of a security to a dealer for his customer, that security could change hands many times before maturity and be sold by many dealers in the secondary market. Our observation is that the market is very broad and deep so that few, if any, firms would routinely sell at least five percent of FHLB bonds. The other securities are similar, although fewer dealers are involved with the PC and GMC markets. We have provided in Appendix C a list of members of our various selling groups. For your assistance, we also have noted those firms and banks that are recognized by the Federal Reserve Bank of New York as reporting dealers. To gain this classification, a firm must maintain a certain volume of activity in the government and agency securities market. These tend to be the major firms and banks in the securities market, and hence we conclude, would be most likely to have the greatest volume in our securities. It is reasonable to assume that some of them have foreign customers.

There has never been to our knowledge a formal meeting between a Federal Home Loan Bank System officer or employee and any representative of OPEC. Our Fiscal Agent indicates he has spoken with representatives of OPEC nations at several business receptions, but only on a casual basis.

IV.

Q. (1) Have there ever been any meetings between any Home Loan Bank System officer or employee and any OPEC investors, including the Saudi Arabian Monetary Agency, other governmental entities, or private investors? If so, please give the details requested below.

(2) Have there ever been any meetings between any Home Loan Bank System officer or employee and any non-OPEC foreign investor, including foreign official institutions, monetary funds, or private investors? If so, please give the details requested below.

As to any and all such meetings (under both (1) and (2)), we want you to furnish: the dates of the meetings, the names of participants, a description of agreements or results, and summaries of what was said by the participants.

A. In early 1979, former Chairman Robert H. McKinney, Charles Myers, Director of the Office of Finance and Fiscal Agent, and Michael Rush, Vice President, Marketing for the Mortgage Corporation visited several countries in Europe. They spoke at meetings of potential foreign investors and met with representatives of several central banks. Their purpose was to acquaint potential foreign investors with the Federal Home Loan Bank System and the Mortgage Corporation and the securities we issue. We have no records of those meetings. Chairman McKinney discussed housing in the United States, the general economy and the savings and loan industry and answered questions regarding the Federal Home Loan Banks and the Mortgage Corporation. The dates and names of the participants in those meetings are listed below:

Date	Place	Attendees, FHLBB	Foreign Institution, Representatives
Jan. 29	London	C. Myers	Orion Bank, Ltd (David Montague, Ian Morgan)
Jan. 30	London	R. McKinney C. Myers M. Rush	Bank of England (John Hill, Dyrek Byatt)
Jan. 30	London	R. McKinney C. Myers M. Rush	Luncheon meeting with approximately 50 institutional investors*
Jan. 31	Frankfurt	R. McKinney C. Myers M. Rush	Deustsche Bank C.M. Kopper (and several others)
Jan. 31	Frankfurt	R. McKinney C. Myers M. Rush	Bundesbank (Dr. Leonhard Gleske)
Jan. 31	Frankfurt	R. McKinney C. Myers M. Rush	Luncheon meeting with approximately 35 institutional investors*

Date	Place	Attendees, FHLBB	Foreign Institution, Representatives
Feb. 1	Zurich	R. McKinney C. Myers M. Rush	Swisse National Bank (Hans Stahel, Mario Conti)
Feb. 1	Zurich	R. McKinney C. Myers M. Rush	Luncheon meeting with approximately 35 institutional investors*
Feb. 2	Basel	C. Myers M. Rush	Bank for International Settlements (Ricky Hall)

* A list of the invitees is available although no record of those actually attending was made.

V.

Q. Finally, we would like you to furnish to the subcommittee any and all documents, including studies, analyses, research papers, internal memos, notes, letters, etc., relating in any way to foreign investment in FHLB or FHLMC securities. (This request also encompasses documents relating to the meetings referred to above.)

A. In connection with your request for all documents relating to foreign investments in FHLB or FHLMC securities, for reasons which I know you will understand, we have not included documents identifying foreign investors in those securities.* We are fearful of jeopardizing our further efforts to sell such securities to them as well as other foreign investors should we disclose such confidential financial data, or matters which may constitute an invasion of personal privacy. I understand that Governor Coldwell of the Board Board of Governors of the Federal Reserve System, in his testimony before the subcommittee several months ago, also alluded to other policy reasons for not disclosing such information. However, I will be pleased to review such material with you on a personal and confidential basis.

Please let me know if we can be further assistance.

Sincerely,

Jay Janis

Enclosures

*Subcommittee Note: On December 19, 1979, Subcommittee unanimously voted for a subpoena to obtain documents in question. Documents thereafter were produced.

APPENDIX 7.—COMMUNICATIONS BETWEEN SUBCOMMITTEE AND CIA/PRESIDENT RELATIVE TO USE OF 17 CIA DOCUMENTS; AND UNCLASSIFIED VERSIONS OF THESE DOCUMENTS ANALYZING OPEC COUNTRY SURPLUS FLOWS, PETRODOLLAR RECYCLING, AND INVESTMENT OBJECTIVES IN U.S. AND WORLDWIDE

September 8, 1981

Hon. William J. Casey
Director of Central Intelligence
Central Intelligence Agency
Washington, D.C. 20505

Dear Director Casey:

In July and October 1979 and in October 1980, the Central Intelligence Agency furnished to the Commerce, Consumer and Monetary Affairs Subcommittee numerous documents relevant to the Subcommittee's investigation of (1) OPEC country surpluses and investment in the United States and (2) the adequacy of Federal agency efforts to monitor and analyze such investment.

The Subcommittee's treatment of these documents is based on a July 1979 "Memorandum of Understanding" signed by former CIA Director Turner and myself. While this Memorandum does not constitute a waiver of the Subcommittee's constitutional and legal rights to have access to and to utilize CIA documents, we have fully adhered to the terms and conditions set forth in the Memorandum. Paragraph 9 of the Memorandum sets forth the procedures under which the Subcommittee can "make public any information furnished by DCI...".

The Subcommittee is in the process of completing its investigation of OPEC and other portfolio investment in the United States. On September 22 and 23 we will hold a hearing on this subject, and subsequently we will issue a report. We may find it necessary to utilize portions of certain CIA documents, as specified in the attachment. The subject matter of these documents is central to the Subcommittee's investigation and forthcoming report.

This letter constitutes the written notification required by the July 1979 agreement. Please have the appropriate member of your staff contact Stephen R. McSpadden of the Subcommittee staff if there are any questions.

Sincerely,

Benjamin S. Rosenthal
Chairman

BSR:mv
Attachment

ATTACHMENT OF DOCUMENTS FOR USE BY SUBCOMMITTEE

(NOTE: The CIA No. before each document is a number assigned by the CIA in connection with the Subcommittee's receipt of it.)

1. CIA 1, Intelligence Report, Problems with Growing Arab Wealth, July 1974, ER IR 74-19.

2. CIA 106, Memorandum for: Pierce L. Bullen, Dept. of State, Subject: "Saudi Arabia: Foreign Official Assets", 22 October 1976, Author: Gary Gray.

3. CIA 117 (77-7), 3-page article, KUWAIT AND SAUDI ARABIA: FACING LIMITS ON U.S. EQUITY PURCHASES, 28 April 1977, EH EIW 77-7.

4. CIA 76-14, 4-page article, Title: KUWAITI INVESTMENT IN THE UNITED STATES, Kuwaiti Investment Policy, (no date).

5. CIA 79-9, 1-page paper, "OPEC: Official Foreign Assets", 10 October 79, NID, 1/TM.

6. CIA 79-27, Intelligence Assessment, "International Payments Implications of Rising OPEC Oil Prices (U)", March 1980, ER 80-10141.

7. CIA 79-12, 3-page paper, "Kuwait: Awash With Oil Money", by Tom Zorn, CIA, 6 November 1979, NID, D/NE.

8. CIA 79-21, (2 rev.), Research Paper, "OPEC Countries: Annual Report on Official Foreign Assets (U)", February 1980, ER 80-10070.

9. CIA 79-23, 4-page article, OPEC: CHAFING UNDER LDC CRITICISM (U), 6 February 1980.

10. CIA 79-26, 4-page article, OPEC: THE 1980 CURRENT ACCOUNT SURPLUS AND ITS PLACEMENT, 27 February 1980.

11. CIA 79-32, 6-page article, INTERNATIONAL PAYMENTS IMPLICATIONS OF RISING OPEC OIL PRICES (U), 19 March 1980.

12. CIA 79-36, 6-page article, OPEC: OFFICIAL FOREIGN ASSETS MOUNT RAPIDLY (U), 25 April 1980.

13. CIA 79-43, 2-page article, "ARAB STATES RECYCLE OIL SURPLUSES TO LDCs, 22 May 1980, SITA.

14. CIA 79-44, 6-page paper or article, "Non-OPEC LDCs: Majority in Economic Trouble (U)", 29 May 1980.

15. CIA 79-47, 4-page paper or article, "Petrodollar Recycling at Midyear(U)", 12 June 1980.

16. CIA 79-95, Intelligence Assessment, "OPEC: The 1980 Current Account Surplus and Its Placement (U)", February 1980, ER 80-10131.

17. CIA 79-97, 1-page paper, "FINANCE: Arab Banks More Active in Reclying", 28 August 1980.

NINETY-SEVENTH CONGRESS

Congress of the United States

House of Representatives

COMMERCE, CONSUMER, AND MONETARY AFFAIRS SUBCOMMITTEE OF THE COMMITTEE ON GOVERNMENT OPERATIONS

RAYBURN HOUSE OFFICE BUILDING, ROOM B-377
WASHINGTON, D.C. 20515

February 9, 1982

The President
The White House
Washington, D.C. 20500

Dear Mr. President:

The Subcommittee on Commerce, Consumer, and Monetary Affairs of the House Committee on Government Operations has been examining the public policy consequences of foreign investment in the United States and the appropriate Federal response to such investments. In July 1979, the subcommittee held four days of hearings on OPEC investments in the United States. In 1981, we held six days of hearings, four of which focused on the Kuwait Government's acquisition of Santa Fe International Corp. and its engineering subsidiary, C.F. Braun & Co..

During the course of our inquiry, the subcommittee received and reviewed numerous U.S. Government documents, both classified and unclassified, relative to OPEC investments in the United States, including over one hundred CIA documents. We believe that publication of 17 CIA documents, as a part of the subcommittee's hearing record, is essential to the Congress' and the public's understanding of the important public policy issues surrounding OPEC government investments in our country. I am writing because the subcommittee and the CIA have been unable to resolve differences over the declassification of the 17 documents.

A July 12, 1979, Memorandum of Understanding (attached) between the Director of Central Intelligence and myself as chairman of the subcommittee, governs the procedures to be followed for declassifying all or part of CIA documents the subcommittee wishes to publish. As the agreement requires, I am hereby notifying you that the subcommittee intends to publish 17 CIA documents, as specified in the attachment to this letter, with certain deletions, acceptable to the subcommittee, to protect CIA intelligence sources.

Under the agreement, the subcommittee can publish the documents, unless the President personally advises me in writing within ten working days of receipt of this letter of his objections to disclosing information contained in the document, providing, for each document, the reasons for his objection and certifying that (1) disclosure of the information involved would "cause a grave injury to national defense or foreign relations, or...compromise sources and methods of intelligence gathering," and (2) "such injury outweighs any public interest served by the disclosure." Should you so object, then pursuant to the agreement, the subcommittee may by majority vote refer the question of disclosure of such information, with a recommendation thereon, to the House of Representatives for its consideration.

The 17 CIA documents at issue deal with (1) the difficulties of recycling OPEC surpluses and suggest alternatives for doing so; (2) the worldwide distribution and placement of OPEC surpluses; (3) OPEC country investment patterns and strategies; and (4) the impact of OPEC investments on U.S. national interests. None contain country-by-country data on OPEC investments in the United States, an omission we relucantly agreed to.

These documents shed light on subjects often shrouded in mystery. Compared with other Federal agency documents, the CIA documents present the best analysis within the Federal Government on the critical public policy issues raised by OPEC government surpluses and investments, including the stability of international and U.S. financial markets in recycling OPEC surpluses; the potential for resolving the recycling problem including OPEC country bilateral assistance; the potential for increasing OPEC government influence in the United States because of the changing nature of OPEC country investments; and the likely course these investments will take in the future.

Some of the CIA documents raise concerns about OPEC investment not expressed by other Government agencies, such as State and Treasury. In congressional hearings and elsewhere, these agencies have repeatedly asserted that there is no basis for concern in the recycling of petrodollars and OPEC investments in the United States. The CIA documents express a different view on the type of investment OPEC governments have been making in the recent past. Without the CIA documents, the public will get a distorted and one-sided Executive Branch view of the nature, extent, and impact of such investment.

The CIA objects to the publication of these documents in any useful form. and has declassified them by making excessive and unjustifiable deletions. In one case, for example, the CIA deleted the entire contents of a five-page document dealing with rapid increases in OPEC official assets. They seek to prevent public disclosure of important but non-sensitive CIA research and prognostications and CIA analyses and conclusions about OPEC surpluses and investments.

I have endeavored unsuccessfully to resolve the differences we have with the CIA about publication of the documents. On January 14, 1981, I spoke with Director Casey. On January 21, 1981, subcommittee staff met with representatives of the CIA at CIA headquarters. However, CIA staff advised him that they would not enter into negotiations to narrow the number and scope of their numerous deletions. Further, it appears that Treasury and State have been given "veto" powers over passages in certain documents. While the subcommittee still remains agreeable to certain deletions to protect CIA sources and to avoid jeopardy to legitimate U.S. national security interests, the present situation, including repeated delays dating back to September 1981, is clearly unacceptable.

The issues surrounding OPEC country surpluses and investments are extremely important. A considered judgment, by the public and the Congress, about the potential benefits and harm of such investment cannot be made and a rational public policy fashioned without this information. Therefore, I respectfully request that you exercise your authority to declassify the contents of the documents involved, deleting only that minimal information which you are authorized to delete under the agreement.

Sincerely,

Benjamin S. Rosenthal
Chairman

BSR:mv
Attachment

cc: Director of Central Intelligence

THE WHITE HOUSE

WASHINGTON

February 17, 1982

Dear Mr. Chairman:

Thank you for your letter dated February 9, 1982, concerning your desire to make public certain CIA reports in your possession.

Director of Central Intelligence Casey informs me that he instructed a group of senior officials within the CIA and Departments of State and Treasury to conduct a second declassification review of the documents at issue, after your respective staffs were unable to agree following an earlier declassification review. The Director informed you on February 11, 1982, of the results of this second review, which identifies additional portions of these reports that may be declassified.

However, based both on the reasons cited in the Director's letter to you and its attachments and on the advice of my immediate staff who have reviewed this matter, I object to the disclosure of that information identified by the Director as requiring classification in the interest of national security. I certify that the disclosure of this information would be likely to cause grave injury to our foreign relations or would compromise sources and methods of intelligence gathering. Further, the public interest in avoiding such injury outweighs any public interest served by disclosure.

I want to stress, however, that this determination in no way restricts the subcommittee's current, complete access to the full texts of these reports. This access certainly should permit pursuit of any legislation that may, in your view, be suggested by your inquiry. Disclosure of the deletions from these reports would only serve to damage the same public interest that such legislation would seek to advance.

Thank you for your cooperation in this matter.

Sincerely,

The Honorable Benjamin S. Rosenthal
Chairman, Subcommittee on Commerce,
Consumer and Monetary Affairs
Committee on Government Operations
House of Representatives
Washington, D. C. 20515

MEMORANDUM OF UNDERSTANDING
BETWEEN THE DIRECTOR OF CENTRAL INTELLIGENCE
AND THE HOUSE GOVERNMENT OPERATIONS SUBCOMMITTEE ON COMMERCE,
CONSUMER, AND MONETARY AFFAIRS

1. The Director of Central Intelligence (DCI) and the Chairman of the House Government Operations Subcommittee on Commerce, Consumer, and Monetary Affairs are prepared to cooperate fully in the inquiries, and any investigation resulting therefrom, being conducted by the Subcommittee regarding OPEC investments.

Access to CIA Information and Personnel

2. The DCI will, when requested, provide access to that classified information originated by the Central Intelligence Agency (CIA) which is relevant to the Subcommittee's mandate. In order to fulfill the DCI's responsibility to protect intelligence sources and methods, such information will be appropriately sanitized, including excising as may be necessary, to assure protection of intelligence sources and methods. The Subcommittee will be notified of any relevant material in the possession of, but not originated by, CIA and provided with the name of the proper authority to contact to obtain access to the material.

3. Access by Subcommittee personnel to any material or information which has been designated for protection from unauthorized disclosure by the Director of Central Intelligence will be limited to one professional staffer and will be granted only on the basis of the standards set out in Director of Central Intelligence Directive (DCID) 1/14. Prior to being granted such access, the designated Subcommittee employee will execute a Secrecy Agreement which is acceptable to the Chairman and the DCI, a copy of which will be provided to the DCI.

4. CIA material at the Secret, non-SCI level may be stored at a location designated by the Subcommittee, provided the storage facility and the access and control procedures are approved by the DCI.

5. CIA material at the Top Secret, SCI level will normally be made available only on CIA premises, where properly cleared staff persons will be provided access on a controlled basis. Notes taken by staff persons in the course of their review of this material will also remain on CIA premises. Copies of the notes, reviewed by CIA for proper classification and sanitization, may be forwarded to the Subcommittee, provided the Subcommittee storage facility meets the higher security standards for this material.

6. Requests for the removal and storage of material classified at the Top Secret, SCI level, other than copies of notes, will be considered by the DCI on a case-by-case basis. Classified material which is removed will not be reproduced.

7. Subcommittee procedures for access, control or storage of any classified CIA material or copies of sanitized notes which Subcommittee personnel may remove from CIA premises, or classified Subcommittee materials generated from them, will be in accordance with security standards established by the DCI. The Subcommittee accepts full responsibility for the proper protection and control of all such material and all discussions based on such materials, in accordance with security standards established by the DCI, while such materials are in the custody of the Subcommittee.

8. At the close of the inquiry or any subsequent investigation resulting therefrom, all CIA material, copies of classified notes, and other classified material generated by the Subcommittee from information furnished by CIA will be transferred to the custody of CIA.

Public Disclosure of CIA Information

9. If at any time the Subcommittee determines that it wishes to make public any information furnished by the DCI pursuant to this Memorandum of Understanding, the Chairman will notify the DCI of this fact in writing. If the DCI does not make a written response within ten working days, the Subcommittee may proceed with such disclosure. The foregoing would not, however, preclude a more rapid response from the DCI in a time urgent situation. If the DCI responds in writing within ten working days, indicating he objects to such public disclosure, the DCI and the Subcommittee will each appoint one representative to meet and attempt to resolve these differences. If these representatives are unable to resolve all points at issue, those remaining points will be taken up by the Chairman and the DCI for resolution. If issues still remain following the discussion between the Chairman and the DCI, the Chairman shall notify the President of the information which the Subcommittee wishes to publicly disclose. The Subcommittee may disclose publicly such information after the expiration of a period of ten working days following the notification to the President unless, prior to the expiration of such ten-day period, the President, personally, in writing, notifies the Subcommittee that he objects to the disclosure of such information, provides his reasons therefore, and certifies that the disclosure would be likely to cause a grave injury to national defense or foreign relations, or would compromise sources and methods of intelligence gathering, and that such injury outweighs any public interest served by the disclosure. The Subcommittee may, by majority vote, refer the question of the disclosure of such information with a recommendation thereon to the House of Representatives for consideration. The Subcommittee shall not publicly disclose such information without leave of the House.

10. If at any time Subcommittee personnel submit to the Chairman, pursuant to the terms of his Secrecy Agreement, material which is intended for publication, the Chairman will consult the DCI for a recommendation concerning the release of information which constitutes or is based upon data to which the DCI has granted access.

11. If at any time the cleared Subcommittee staffer is called upon by Judicial or Legislative authorities to testify about or provide information which he has agreed not to disclose pursuant to his Secrecy Agreement, the Chairman will so notify the DCI or his representative.

Condition for Suspension of Access

12. Any disclosure of information in violation of this Memorandum of Understanding may result in the suspension of further access to CIA documentary information or current CIA employees by Subcommittee personnel.

S/
Director of Central Intelligence

Date

Chairman, House Government Operations Subcommittee on Commerce, Consumer, and Monetary Affairs

7/12/79
Date

Central Intelligence Agency

Washington, D.C. 20505

11 February 1982

Honorable Benjamin S. Rosenthal
Chairman, Subcommittee on Commerce,
Consumer and Monetary Affairs
Committee on Government Operations
House of Representatives
Washington, D.C. 20515

Dear Ben:

A senior group of officials has completed a second review of the 17 documents you requested to be sanitized and declassified for your Subcommittee's public use. This review was conducted by Senior Intelligence Service members from the CIA's Directorates of Intelligence and Operations and senior representatives from the Departments of Treasury and State. I had the documents reviewed a second time to assure that there would be no withholding not required to meet our obligation to protect sources, methods, and US foreign policy interests. The results of that review are enclosed.

I hope the documents will be useful to your investigation. Please let me know if we can be of further assistance.

Sincerely,

Bill

William J. Casey
Director of Central Intelligence

Enclosures

86-722 O - 82 -55

ATTACHMENT OF DOCUMENTS FOR USE BY SUBCOMMITTEE

(NOTE: The CIA No. before each document is a number assigned by the CIA in connection with the Subcommittee's receipt of it.)

1. CIA 1, Intelligence Report, Problems with Growing Arab Wealth, July 1974, ER IR 74-19.

2. CIA 105, Memorandum for: Pierce L. Bullen, Dept. of State, Subject: "Saudi Arabia: Foreign Official Assets", 22 October 1976, Author: Gary Gray.

3. CIA 117 (77-7), 3-page article, KUWAIT AND SAUDI ARABIA: FACING LIMITS ON U.S. EQUITY PURCHASES, 28 April 1977, ER EIM 77-7.

4. CIA 76-14, 4-page article, Title: KUWAITI INVESTMENT IN THE UNITED STATES, Kuwaiti Investment Policy, (no date).

5. CIA 79-9, 1-page paper, "OPEC: Official Foreign Assets", 10 October 79, NID, 1/TM.

6. CIA 79-27, Intelligence Assessment, "International Payments Implications of Rising OPEC Oil Prices (U)", March 1980, ER 80-10141.

7. CIA 79-12, 3-page paper, "Kuwait: Awash With Oil Money", by Tom Zorn, CIA, 6 November 1979, NID, D/NE.

8. CIA 79-21, (2 rev.), Research Paper, "OPEC Countries: Annual Report on Official Foreign Assets (U)", February 1980, ER 80-10070.

9. CIA 79-23, 4-page article, OPEC: CHAFING UNDER LDC CRITICISM (U), 6 February 1980.

10. CIA 79-26, 4-page article, OPEC: THE 1980 CURRENT ACCOUNT SURPLUS AND ITS PLACEMENT, 27 February 1980.

11. CIA 79-32, 6-page article, INTERNATIONAL PAYMENTS IMPLICATIONS OF RISING OPEC OIL PRICES (U), 19 March 1980.

12. CIA 79-3, 6-page article, OPEC: OFFICIAL FOREIGN ASSETS MOUNT RAPIDLY (U), 25 April 1980.

13. CIA 79-43, 2-page article, "ARAB STATES RECYCLE OIL SURPLUSES TO LDCs, 22 May 1980, SITA.

14. CIA 79-44, 6-page paper or article, "Non-OPEC LDCs: Majority in Economic Trouble (U)", 29 May 1980.

15. CIA 79-47, 4-page paper or article, "Petrodollar Recycling at Midyear(U)", 12 June 1980.

16. CIA 79-95, Intelligence Assessment, "OPEC: The 1980 Current Account Surplus and Its Placement (U)", February 1980, ER 80-10131.

17. CIA 79-97, 1-page paper, "FINANCE: Arab Banks More Active in Reclying", 28 August 1980.

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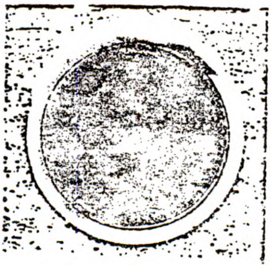

[redacted]

FILE COPY

[redacted] Report

Problems With Growing Arab Wealth

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Problems with Growing Arab Wealth

KEY JUDGMENTS

Higher oil prices are dramatically altering the international payments system. If they continue:

- OPEC earnings in 1974 will total about $90 billion and the current account surplus will exceed $60 billion.

- The surplus is likely to decline after 1974, but it will not be eliminated until the 1980s.

- Foreign holdings – [redacted] will be increasingly concentrated in the Arab states, particularly Saudi Arabia, Kuwait, Libya, and the Persian Gulf sheikdoms.

Arab investment has been concentrated in financial markets in a few developed countries, particularly the Eurodollar market. Most holdings are in short-term assets, particularly bank deposits. [redacted]

[redacted]

Oil consumers will face increasing difficulty in financing their oil-related current account deficits.

Note: Comments and queries regarding this report are welcomed. They may be directed to [redacted]

- Developing nations and some developed countries with especially large current account deficits will be shut out of financial markets and will be unable to obtain market financing on almost any terms.

- Many credit-worthy countries will be unwilling to incur a rapidly mounting debt and debt service burden.

In the absence of an international consensus on an acceptable pattern of current account deficits and the means of financing them, the consuming countries will take independent steps to cope with the oil payments problem. For those countries with a weak balance of payments, such steps could include more restrictive demand management policies and specific measures for stimulating exports and limiting imports. Such policies would tend to shift oil related deficits to the countries best able to finance them – the United States and West Germany.

A number of proposals have been advanced to attract and recycle Arab funds through existing official institutions, such as the IMF, World Bank, and some new joint producer-consumer investment institutions, but these channels are unlikely to handle more than a small share of the oil money. Despite the plethora of schemes for direct producer country aid to consumers, these will provide relief for only a few, primarily Islamic, states.

If new arrangements are not implemented, there will be a large inflow of oil money to the United States. While there will be some outflow of these funds they are certain to fall far short of financing oil deficits in other consuming countries. [redacted]

New arrangements could be implemented to facilitate recycling through the US market. These could take a variety of forms: encouraging private capital outflows, direct official long-term loans, and new long-term swap arrangements, some of which probably would be on concessionary terms. To the extent that recycling took place, other countries would be under less severe pressure to minimize their balance-of-payments deficits.

INTRODUCTION

1. Higher oil prices have dramatically transformed the international payments situation. Oil exporters are generating enormous current account surpluses because their growing receipts have been only partly offset by increased imports of goods and services. The resulting buildup of foreign holdings by oil producers – particularly Arab countries – is a critical new element in international capital and exchange markets. Even if oil prices drop by a few dollars per barrel, this buildup will not cease but will merely become less pronounced.

2. This report examines some of the difficulties raised by the Arab oil producers' massive accumulation of wealth. It analyzes the likely impact of these holdings on international financial markets, given the present institutional arrangements and Arab investment preferences. It also briefly considers some of the schemes proposed to facilitate the recycling of oil revenues to importing countries.

3. The present pattern of Arab foreign investment and each of the proposed investment options are evaluated on their ability to satisfy a number of producer and consumer objectives. Paramount among the consumer objectives is the need to finance this year's pattern of oil-related current account deficits and to finance an acceptable distribution of deficits for years to come. This report, however, does not consider what an acceptable or desirable pattern of current account deficits would be, or what policies in addition to providing adequate financing on favorable terms would be needed to achieve this distribution.

4. The transformation in the international payments system now taking place is so new and unfamiliar that wide differences exist as to its likely impact. Some experts, particularly members of the banking community, fear that – unless oil prices fall sharply – a financial collapse is inevitable without a major restructuring of the financial system. Others are more sanguine and believe that financial markets will be able to accommodate the Arab oil producers' massive accumulation of wealth with only ad hoc adjustments.

DISCUSSION

Revenue and Expenditure Prospects, 1974 and Beyond

5. The sharp increase in oil prices is substantially boosting producer earnings. OPEC revenue now averages almost $300 million a day. Earnings in 1974, despite the lag in first quarter payments, will total about $90 billion, three times greater than in 1973. Arab states account for about one-half of the receipts, with Saudi Arabia receiving the largest share.

6. Even before the recent oil price increases, the earnings of Saudi Arabia, Kuwait, Libya, and the Arab Persian Gulf states exceeded their ability to absorb foreign goods and services. Small populations and limited domestic investment opportunities continue to retard the growth of imports. In 1974, their combined current account surplus should exceed $30 billion.

7. The major non-Arab oil exporters – Iran, Indonesia, Nigeria, and Venezuela – and two other Arab producers – Algeria and Iraq – are finding it easier to expand imports. For the most part, these countries have relatively large populations and greater opportunity for internal development. Nevertheless, for these countries as a whole, revenue increases are also outstripping their absorptive ability. In 1974 their combined current account surplus will total about $30 billion.

8. Projecting OPEC revenue and expenditure beyond 1974 is hazardous. Much depends on the future response of producers and consumers, individually and collectively, to present high prices. A consensus among oil experts is emerging, however, on likely developments during 1975-80:

- Oil revenue (in 1974 dollars) will decline by 1980.[1] Even with optimistic assumptions about consumer and supply response to high oil prices, oil earnings will be lower in 1980 than in 1974.

- Increased investment earnings will more than make up for the drop in oil revenues.

- Spending on foreign goods and services will increase rapidly. It is unlikely to quadruple, however, eliminating the current account surplus by 1980 as projected by OECD.

- Reserve holdings will be increasingly concentrated in Saudi Arabia, Kuwait, Libya, and the Arab Persian Gulf states.

A drop in oil prices of $2-$3 a barrel during this period would not significantly alter these trends.

9. If these projections are borne out, the problems arising from the oil producers' accumulation of wealth will gradually change. The producers' current account surplus will decline both absolutely and relative to world trade and production, but the producers' wealth will continue to increase [redacted]

1. The OECD estimates that, at a constant price of $9.20 per barrel, oil earnings will peak at $96 billion in 1976 and decline to $93 billion in 1980 [redacted]

Present Arab Foreign Investment Patterns

[redacted]

- [redacted]
- [redacted]
- [redacted]

[redacted]

11. Arab investment is concentrated in financial markets in just a few developed countries. [redacted] Arab producers are still unwilling to place funds directly in non-Islamic developing countries, and discussions with the World Bank Group and the IMF have not yet led to a substantial flow of funds into these institutions.

Table 1

Currency Denomination of Official Arab Foreign Assets[1]

	Percent
Eurodollars	[redacted]
US dollars	[redacted]
Sterling	[redacted]
Other developed countries' currencies	[redacted]
Developing countries' currencies	[redacted]
Gold and reserve position in the IMF	[redacted]

1. Weighted average for Saudi Arabia, Kuwait, Libya, and the United Arab Emirates on 31 December 1973. [redacted]

[redacted]

12. Most Arab holdings are in liquid assets, particularly bank deposits (see Table 2). Bank deposits generally do not pay the highest return, but they are safe, easily managed, and [redacted] The Arabs are shifting toward longer term assets, however, as their wealth and investment sophistication increase.

Table 2

Composition of Official Foreign Assets

	Percent
Bank deposits	[redacted]
Highly liquid (current and call accounts)	[redacted]
Relatively liquid (time accounts and certificates of deposits)	[redacted]
Treasury stocks and bonds	[redacted]
Selected notes and loans	[redacted]
Gold and reserve position in the IMF	[redacted]
Other foreign assets, including equities and real estate	[redacted]

13. Arab producers continue to rely heavily on the Eurodollar market because it satisfies their investment objectives. Eurodollar bank deposits, government issues, and blue chip securities are relatively free from economic and political risks. Interest rates are high enough to maintain the real value of assets except in periods of unusually rapid inflation. These investments also provide a high degree of flexibility, allowing changes in asset composition for political or economic reasons.

14. At present, the US financial market is the only other market in which Arab investment objectives can be realized. US interest rates, however, are generally lower than those in the Eurodollar market. This stems in part from the Eurodollar market's higher risk and the absence of reserve requirements similar to those on US banks. [redacted] Financial markets in other developed countries are too small or controlled to handle the massive flow of Arab funds.

Implications of Present Arab Foreign Investment Patterns

15. Arab oil producers' continuing reliance on financial markets in a few developed countries, especially the Eurodollar market, raises a number of important questions.

- Can these markets continue to assimilate the massive sums involved without increasing potential market instability or depressing rates on Arab deposits to a level inconsistent with producers' objectives?

- Will they be able to recycle producers' surpluses to all consuming countries needing to finance increased oil import bills?

- Will funds be available on terms that will induce consumers to avoid beggar-thy-neighbor policies while allowing time for gradual adjustment and redistribution of their total current account deficit?

Can Financial Markets Assimilate Arab Funds?

16. The flow of Arab funds into financial markets is huge, but the markets in the aggregate are large enough to assimilate the inflow without seriously endangering their viability or depressing rates. The total value of financial assets in developed countries — most of which are dollar denominated — exceeds $4 trillion. The annual value of new issues is in excess of $400 billion. Moreover, government policies, including measures resulting from the need to finance higher oil import bills, can bring about an increase in new issues and thus in the market's size.

17. Concentration of Arab investment in the Eurodollar market, however, is placing a growing strain on it [redacted] If present trends continue, the net value of Eurodollar assets and liabilities could jump nearly 50% this year, to about $200 billion. [redacted]

18. Many financial analysts believe the Eurodollar market is quickly reaching the limits of prudent expansion and are reevaluating its weaknesses. These include:

- The potential instability of the deposit base, reflecting the fact that a few oil producers control a substantial and growing proportion of the market's deposits.

- The extremely low and declining equity ratios of most banks active in the market.

- The absence of effective government controls over Eurobank operations and of an assured lender of last resort to assist a bank with liquidity problems.

The failure of an important Eurodollar bank in the near future is unlikely, although the potential is increasing.

19. Growing concern over the Eurodollar market's ability to assimilate producers' revenue is already becoming evident even though the increased flow of Arab funds began only in April when the first quarterly oil payments reflecting the higher prices were received. [redacted]

[redacted]

Can Financial Markets Adequately Recycle Surpluses?

21. The flow of Arab funds is by its very nature more than adequate to finance the overall oil payments deficits of consuming countries, but financial markets will be unable to supply each country with exactly the amount it needs. Countries that are creditworthy are easily obtaining necessary financing through direct and indirect borrowing by the government. Many developing countries and some developed countries with especially large current account imbalances, however, have been shut out of financial markets because of their bleak economic outlook. Some of these would have had difficulty in financing their current account deficits in any case, but higher import bills now make market financing clearly impossible. Less than one-third of the consuming countries' total oil-related current account deficit probably will be financed through market borrowing in 1974.

22. Developing countries will receive far less than the $8.5 billion needed to offset the additional cost of oil this year.[3] Loans to finance oil-related balance-of-payments deficits are relatively unattractive to lenders. Moreover, concern about the security of outstanding loans and about mounting payments imbalances has led to a tightening of credit standards. Many developing countries, particularly those with high debt-service burdens and without rich mineral

3. For a more detailed discussion of the oil financing problems of developing countries, see [redacted]

endowments, are now unable to borrow. More are likely to be excluded at some point as their debts grow. Thus the financing needs of the developing countries increasingly will have to be handled outside the market.

23. Some developed countries with comparatively large current account deficits [redacted] are also having difficulty obtaining adequate market financing. [redacted]. Other developed countries with especially large current account deficits will also be excluded from the market as their oil-induced borrowings grow [redacted] These countries may be forced to seek a rapid adjustment in the non-oil elements of their current account to finance their higher oil import bills.

24. The recent agreement in principle to allow countries to use their gold reserves as loan collateral is unlikely to substantially increase borrowings by countries now shut out of the market. Borrowers will be reluctant to provide a gold guarantee, in part because it will prejudice their ability to get further credit without similar guarantees. At the same time, banks will discount the pledge's value because of difficulties in enforcing it and uncertainties about gold's future price, particularly if prospects are for substantial sales from official stocks.

Will Funds Be Available on Favorable Terms?

25. Funds will not be available in financial markets at low enough cost and long enough maturity to induce consumers to finance higher oil import costs for a sufficient period to allow gradual adjustment to an acceptable pattern of current account deficits. The continuing Arab preference for liquid assets limits the market's ability to offer the long-term loans that borrowers need. Moreover, consumers must pay a rate equal to that paid on Arab deposits, plus an increasing spread to reflect the growing risks of intermediation.

26. Consuming countries have a strong need for long-term loans. Their oil-related current account deficits are not expected to be reduced substantially until 1980, and will not be eliminated entirely for several more years. Extremely long loan maturities are required [redacted]

27. Although financial markets in the aggregate are certain of retaining the Arab deposit base from which long-term loans can be made, this is not true for individual institutions or markets. If an unexpected drawdown occurs in one bank's deposits, that bank could be forced to borrow at interest rates substantially above those charged on current loans. As a consequence, oil-financing loans invariably

have been for maturities of less than 10 years and have provided for regular interest rate adjustments – usually every 6 months.

28. The need to refinance oil-related debts will complicate the continuing task of financing higher oil import bills for all countries. Debt service requirements – interest and repayment of principal – will build up quickly, rapidly exhausting the borrowing potential of many otherwise creditworthy consumers. The mounting debt service burden and overhang of past liabilities will also force many other consuming countries that still qualify for further loans to limit their borrowing. Debt service requirements will simply be perceived as being too great, particularly given uncertainties about future interest rate charges. These countries will join those unable to borrow in seeking a more rapid adjustment in the non-oil elements in their current account.

29. The consuming countries' oil-related debt service burden in 1975 will total about $6 billion, at current interest rates. If consuming countries finance their total oil-related current account deficits in the market, the additional interest payments will exceed $30 billion in 1980. [redacted]

Implications for Producers

30. Arab oil producers presently have little incentive to shift their investments from financial markets in a few developed countries (see Table 3). They will be less willing to concentrate their holdings in the Eurodollar market, however, as strains become more evident. [redacted]

Implications for Consumers

31. Existing arrangements for assimilating and recycling Arab funds are not up to the task over the long run – and perhaps not even this year. The only possible advantage of sticking with them for a time is that extreme financial difficulties in certain consuming countries will induce some producers [redacted] to endeavor to lower oil prices. If oil prices do not soon fall substantially. [redacted]

Table 3

[redacted]

32. Oil consumers that are unable or unwilling on available terms to finance their oil-related current account deficits will have to impose restrictive trade measures or deflate their economies. For the countries as a group, either course will add to the direct deflationary impact of the oil price rise, increasing the danger of a worldwide recession. Part or all of the oil-related current account deficits of certain consuming countries will necessarily be shifted to others that happen to be able to internally finance the increase in oil-producer reserves. The latter countries are primarily the United States – which has the singular ability to create dollar assets without offsetting liabilities – and West Germany – which has the world's largest dollar reserves, now about $34 billion.

33. If the attempted redistribution of the deficit becomes unacceptable to these two countries, all consumers will adopt beggar-thy-neighbor policies in a futile effort to reduce their payments imbalances. This danger has been explicitly recognized in the current-account standstill agreement approved at the OECD Ministerial Meeting in early June. Despite this agreement, the threat will grow unless new financial mechanisms are found to recycle oil producers' surplus funds to all consuming countries on terms that will induce them to finance higher oil import bills for a sufficient period to allow gradual adjustment and redistribution of their total current account deficit.

Alternative Investment Arrangements

34. Numerous proposals have been made to modify the financial structure to better accommodate and recycle the massive inflow of Arab funds. The suggested options fall into two broad categories:

- Those in which multilateral organizations circumvent the market by directly attracting and recycling Arab funds to consuming countries.

- Those in which official financial institutions, primarily central banks and treasuries, assist the market in attracting and recycling Arab funds by guaranteeing adequate liquidity and providing new financial instruments.

Circumventing the Market

35. Three types of arrangements have been advanced to recycle Arab funds through official institutions. First, institutions controlled primarily by oil consumers could intermediate between Arab investors and consuming countries. Second, producer-controlled institutions could channel surpluses to designated consuming countries. Third, joint producer-consumer institutions could invest the surpluses.

Institutions Dominated by Consuming Countries: IMF, World Bank Group, BIS, and EC

36. A new IMF facility, suggested by Managing Director Witteveen, would increase members' maximum drawings from the Fund by $19 billion in 1974-75. Less than $3 billion of this sum would be available to developing countries. Drawings to finance higher oil import bills would be repayed within 3-7 years and would carry an interest charge of about 7%. The IMF would need an additional $12 billion to supplement existing resources if all eligible members, including the United States, exercise their drawing rights. So far, oil producers have pledged only about $3.5 billion: moreover, some pledges call for interest rates in excess of 10%, while others are not definite commitments. Substantial additional Arab funds will be attracted only by offering special inducements, such as exchange rate guarantees or above-market interest rates.

37. The World Bank Group is seeking to increase its long-term lending to developing countries by attracting more oil-producer money. No target for additional funding has been set. World Bank teams recently visited major producers and obtained commitments to subscribe to about $750 million in additional World Bank bonds this year.

[redacted]

[redacted]

39 [redacted]

40. Consuming countries, particularly those most in need, likewise will find such arrangements inadequate. At best, they will provide only marginal assistance to a few countries. Many developing countries that have been shut out of financial markets fail to qualify for World Bank loans. These countries will also derive little from the IMF facility because access is based on increased oil import costs rather than need. Some developed countries with especially large current account deficits, such as Italy, could benefit from an IMF, BIS, or EC facility by gaining increased access to funds. Nevertheless, the terms of the assistance – near-market interest rates and repayment within 3-7 years – probably would not be sufficiently attractive to encourage the country to finance oil-related deficits long enough to allow gradual current account adjustment.

Producer Institutions

41. Oil producers are considering a number of proposals to create new aid facilities or to enlarge and broaden access to existing ones (see Table 4). The authorized capital of existing programs is almost $4.6 billion; the capital of the proposed institutions is about $13 billion. Actual loan authorizations, however, currently total less than $500 million, and assistance has been concentrated in a few Arab countries.

42. The huge gap between proposed capitalization and actual loan authorizations is likely to persist. Loans to developing countries carry a substantial economic risk, while rates of return are significantly below those offered in the market. Despite commitments to broaden access to all developing countries, aid from the oil producers' funds will continue to be concentrated in a few Islamic states. The facilities provide no assistance to developed countries in meeting payments needs.

Table 4

[redacted]

Joint Producer-Consumer Institutions

43. No concrete proposals for major joint producer-consumer institutions have yet been formulated although a number of small joint investment banks currently exist. Such institutions could take a variety of forms. A multilateral investment bank, for example, could issue to oil producers long-term securities

guaranteed against loss. The bank could invest the proceeds in real and financial assets in a number of consuming countries. Producers and consumers could jointly manage the bank.

44. [redacted]

45. If producer surpluses were channeled through some joint financial institutions, producers would benefit because their investments would be protected through portfolio diversification and the earning of market-level returns. International guarantees would also provide security against seizure of the assets. Producers would, however, lose some control over their holdings.

46. The principal advantage for consuming countries is that some of the funds burdening a few financial markets would be siphoned off and distributed more in line with consumers' needs. Loans would constitute only a portion of the institution's placements; thus debt service burdens would be smaller than with exclusive reliance on market borrowing. [redacted] Such arrangements nonetheless would provide little assistance to countries offering limited investment opportunities. Producer participation could also add to their cohesiveness and thus contribute to the maintenance of high oil prices.

Assisting the Market

47. No major new mechanisms have yet been proposed to help financial markets absorb and recycle Arab funds. The various forms such mechanisms could assume can be divided into two broad groups: techniques to bolster the Eurodollar market by assuring adequate liquidity in time of crisis; and measures to make national financial markets more attractive, both to oil producers and consumers.

Eurodollar Market

48. The Eurodollar market's weaknesses can be largely offset by requiring higher equity ratios for participating banks and by establishing the equivalent of a lender of last resort. Central banks could jointly guarantee oil financing loans or provide funds to parent banks in support of their Eurodollar branches, if necessary. Alternatively, they could directly support the market, perhaps using the BIS framework. [redacted] The final lenders of last resort, however, would have to be [redacted]

49. The assurance that adequate funds would be available to the Eurodollar market in time of crisis is advantageous to oil producers but probably does little for most consumers (see Table 3). Arab investors would be able to satisfy their objectives through Eurodollar placements with less fear of eroding the market's underlying strength and stability. A strengthened Eurodollar market would still face difficulties, however, in recycling the inflow to all consuming countries on favorable terms.

National Financial Markets

50. Problems in absorbing and recycling Arab funds would be reduced substantially if financial markets in most consuming countries could attract Arab money directly. If capital inflows into each national market exactly offset that country's oil-related current account deficit, there would be no need for further external financing; the recycling task would be directly accomplished. Although placements of funds could never be expected to match consumer needs exactly, any substantial inflow into a large number of national markets would make the recycling task more manageable.

51. Only a few national markets will be able to attract Arab funds even if special financial instruments or other incentives are offered. Most markets offer few suitable assets, and the risk of economic loss or political seizure is felt to be too great. Moreover, their small size would cause Arab investors to lose freedom of action. [redacted]

52. [redacted] It is the only market, other than the Eurodollar market, able to meet their investment objectives because no other offers the amount and variety of assets demanded. [redacted]

53. [redacted]

54. [redacted] but it will be unable to recycle them to all consuming countries on favorable terms.

[redacted] Traditional private instruments cannot finance the oil-related current account deficits of countries with poor credit standing. Neither can they provide funds on terms at which consumers would be more willing to finance large oil-related current account deficits long enough to allow gradual current account adjustment and redistribution.

55. [redacted] These could take a variety of forms. They include:

- Encouraging private capital outflows to countries with oil-related payments deficits through guarantees against expropriation, default, or other adverse occurrences: tax incentives; and elimination of remaining restrictions on capital movements.

- Direct official long-term loans at subsidized interest rates, possibly tied to future oil price or current account developments.

- New long-term swap arrangements which could be organized within the IMF framework or, for EC members, as part of the Community's monetary structure.

Other consumers with large dollar holdings, [redacted] could provide similar incentives to stimulate capital outflows.

[redacted]

[redacted] Countries providing new arrangements to facilitate financing of oil-related current account deficits could incur substantial net interest costs, but they would probably be smaller than the costs incurred under alternative options. By initially incurring a larger share of the financing costs, [redacted] providing special arrangements would facilitate gradual and less disruptive adjustment to higher oil import bills.

Prospects

58. The massive flow of Arab funds into the Eurodollar market will continue for only about 4-6 months. As Eurodollar rates on Arab deposits decline and other strains become more evident [redacted]

59. [redacted] Planned consumer-controlled facilities will be able to handle only a small portion of the producers' surpluses and will not offer borrowers acceptable lending terms. The plethora of proposed producer aid schemes will provide relief for only a few, primarily Islamic, states. The problems involved in establishing joint producer-consumer institutions will retard their growth. Such arrangements will also provide little assistance to countries offering limited investment opportunities.

60. [redacted]

61. [redacted]

[redacted]

[redacted]
WASHINGTON, D.C. [redacted]

22 October 1976

MEMORANDUM FOR: [redacted]
Office of Energy and Fuels
Department of State

SUBJECT : Saudi Arabia: Foreign Official Assets

1. Our most recent estimates of Saudi assets, in response to your request of 20 October, are as follows: [redacted]

2. The projection for 1980 assumes a [redacted] Thereafter, prices of oil and other Saudi exports and Saudi imports are projected to increase at a [redacted] annual rate.

3. If you have further questions, please call [redacted] or me on IDS code [redacted], extension [redacted]

[redacted]

[redacted]
Chief
[redacted]

Distribution:

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

* * * * *

EH [redacted] 28 April 1977

4A,2F 77-7

KUWAIT AND SAUDI ARABIA: FACING LIMITS ON US EQUITY PURCHASES

[redacted]

[redacted]

[redacted]

[redacted]

22

[redacted]

28 April 1977

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

23

[redacted]

25 April 1977

[redacted]

* * * * *

[redacted]

Kuwaiti Investment in the United States

Kuwaiti Investment Policy

We have identified from press sources five US corporations -- General Motors, General Electric, Kodak, Minnesota Mining, and Southern Pacific -- included in Kuwait's current US stockholdings.

We are confident that Kuwait's other US equity holdings reflect the Kuwaiti preference for safe and diversified investments.

[redacted] With oil as its only substantial resource and a population of 1 million, the potential for domestic economic development is limited. Foreign investment is viewed as a serious long-term business which will gradually replace oil production as the major source of its income. [redacted]

p.1

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

In 1975, Kuwait channeled nearly . into US investments, approximately . into long-term equity holdings. [redacted]

Total Kuwaiti investment in the United States reached [redacted] at yearend 1975. The attached tables present our estimates of the disposition of Kuwait's total foreign assets at the end of 1974 and 1975 by asset type, location and currency denomination.

[redacted]

[redacted]

OPEC: Official Foreign Assets

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

International Payments Implications of Rising OPEC Oil Prices

An [redacted] Assessment

[redacted]

p. 11

[redacted]

[redacted]

March 1980

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[redacted]

International Payments Implications of Rising OPEC Oil Prices (U)

Summary

As with the large oil price increases of 1973-74, the current upsurge in prices charged by the Organization of Petroleum Exporting Countries is affecting the world economy in a number of profound ways. It is placing downward pressure on real economic activity and pushing up consumer prices. Renewed major imbalances in international payments positions are also being generated, creating considerable anxiety about the willingness and ability of the international banking system to finance some of the deficits. [redacted]

[redacted] the Organization for Economic Cooperation and Development and the non-OPEC less developed countries (together referred to as the non-OPEC countries) [redacted]

Of the more than [redacted] increase in the current account deficit projected for the non-OPEC countries between 1978 and 1980, about one-half is expected to be absorbed by [redacted], countries with very strong payments positions in 1978. In addition, certain individual countries—[redacted]—have already altered economic policies to forestall potential financial difficulties. [redacted]

Beyond 1980, anxieties about strains on the international financial system are much more justified. Unlike the situation in 1974-78, when relatively constant nominal oil prices and sharply rising OPEC imports led to a near-elimination of the OPEC surplus, [redacted]

Although there are more numerous safeguards to counter recycling difficulties this time around, [redacted]

8-6, iii

[redacted]. Even if loanable funds are available, debtor countries may not be so willing as in earlier years to further increase their indebtedness. [redacted]

[redacted]

We expect adjustment to be greatest among [redacted] The first two groups will see growth rates reduced through their trade accounts, by surging oil bills and dampened exports to major OECD markets. Most of them will probably be able to attract enough funds to sustain moderate but appreciably lower rates of economic growth than they have been accustomed to. [redacted] will be more vulnerable because of their narrower export base. Tighter private lending policies for them probably will mean sharply reduced economic growth over the longer term. [redacted]

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[redacted]

International Payments Implications of Rising OPEC Oil Prices (U)

A Review of 1974-78

Current anxieties over the international financial community's ability to recycle large OPEC current account surpluses are similar to those accompanying the oil price explosion of 1973/74. In 1974 the roughly $8 per barrel rise in OPEC oil prices pushed OPEC's current account surplus, excluding official transfers, to $72 billion. This was equivalent to almost 9 percent of total exports of goods and services of the OECD countries and non-OPEC LDCs. At the time, most analysts expected the large OPEC surpluses to continue, creating monumental international financial problems. (U)

These pessimistic expectations did not materialize for a variety of reasons:

- OPEC oil prices, after hitting a temporary peak of $11.36 per barrel in the first quarter of 1974, remained roughly constant over the next four years. At the end of 1978 they stood at only $12.91 per barrel.
- OECD real GNP was almost stagnant in 1974-75 and increased at only a 2.5-percent average annual rate for the entire 1974-78 period.
- OECD oil use per unit of real GNP fell 8 percent in 1974-78 which, coupled with increased non-OPEC oil production, helped to hold OPEC oil exports in 1978 below the 1973 level.
- OPEC import volume rose at an average annual rate of about 25 percent in 1974-78, as OPEC spent three-fourths of its cumulative $600 billion oil revenues.
- Net external lending by private financial institutions soared from $25 billion in 1973 to $36 billion in 1975, and to $85 billion in 1978. (U)

The OPEC surplus was more than halved in 1975 and, after rising slightly in 1976 as economic recovery in the OECD countries set in, almost disappeared by 1978. Japan, West Germany, France, the United Kingdom, and Italy recorded the bulk of the improvement in the non-OPEC countries' payments position. On the other hand, the US and Canadian current account positions in 1978 were much worse than those experienced in 1974 (see table 1). As for the non-OPEC LDCs, their combined deficit peaked at $34 billion during the OECD recession of 1975, then declined until 1978 when it rose to $30 billion. (U)

The 1979 Reversal

During 1979, market uncertainties triggered by the Iranian revolution led initially to a sharp runup in spot oil prices and ultimately to marked upward revisions in official OPEC prices. From late 1978 to early 1980, the OPEC average official sales price rose from $13 per barrel to about $29. On a yearly basis OPEC prices averaged $18.66 per barrel in 1979, compared with $12.93 in 1978. The surge in oil prices during 1979 led to a reversal in the current account trends of the previous five years. The OPEC surplus climbed to almost $75 billion and the combined deficits of non-OPEC countries worsened by an approximately equal amount (see table 2). (U)

Despite the swing in current account positions, no major international financial difficulties arose last year. Two factors played a role in that outcome. First, most of the shift toward deficits occurred in the financially strong OECD countries. Of the combined $55 billion deterioration in the current account balance of the non-OPEC countries in 1979, nearly $45 billion was absorbed by Japan, West Germany, and the United Kingdom. The worsening last year in the current account balances of the smaller OECD countries and non-OPEC LDCs—groups including many countries with weak external financial positions—totaled $20 billion. Although some non-OPEC LDCs did experience substantial deteriorations in their current account positions last year—most notably, Argentina, Brazil, and South Korea—the new positions were easily financed. (U)

[redacted]

[redacted]

Table 1 Billion US $

Non-Communist Countries: Current Account Trends [1]

	1974	1975	1976	1977	1978
Total OECD and non-OPEC LDCs [2]	−38.1	−19.2	29.8	−31.3	−2.8
OECD	−14.1	14.8	−4.8	−9.3	27.2
United States	8.5	22.3	9.0	−10.0	−8.8
Big Six	−12.2	1.6	−0.3	19.9	42.9
Japan	−4.5	−0.1	4.2	11.5	16.9
West Germany	13.1	8.1	7.2	8.6	12.2
France	−4.7	1.3	−4.9	−1.5	5.4
United Kingdom	−7.0	−2.8	−0.1	2.5	5.2
Italy	−7.5	−0.2	−2.7	2.9	7.7
Canada	−1.6	−4.7	−4.0	−4.1	−4.4
Smaller OECD Of which:	−10.4	−9.0	−13.5	−19.2	−6.8
Denmark	−1.2	−0.6	−2.2	−2.1	−2.0
Greece	−1.2	−1.0	−1.1	−1.3	−1.3
Portugal	−0.8	−0.7	−1.2	−1.5	−0.7
Spain	−3.2	−3.5	−4.3	−2.4	1.8
Sweden	−0.3	−0.7	−1.4	−2.1	NEGL
Turkey	−0.7	−1.9	−2.3	−3.4	−1.4
Non-OPEC LDCs Of which:	−24.0	−34.0	−25.0	−22.0	−30.0
Non-oil-exporting LDCs Of which:	−19.0	−26.0	−20.0	−18.0	−23.0
Argentina	1.2	−1.3	0.6	1.0	2.2
Brazil	−7.6	−7.0	−6.6	−5.1	−7.0
Chile	−1.2	−0.6	1.4	−0.5	−0.8
Hong Kong	NEGL	−0.4	−0.2	−0.3	−0.6
India	−0.8	−1.2	0.7	1.0	0.4
Ivory Coast	−0.1	−0.4	−0.3	−0.2	−0.5
Pakistan	−1.0	−1.2	−0.9	−0.8	−0.8
Philippines	−0.3	−1.0	−1.1	−0.9	−1.3
South Korea	−2.1	−2.0	−0.5	−0.1	−1.2
Taiwan	−1.1	−0.6	−0.3	1.0	1.7
Thailand	−0.6	−0.4	−1.1	−1.2	−1.2
OPEC	71.6	33.8	35.7	30.1	7.8
Memoranda					
OPEC oil prices (US $ per barrel)	11.28	11.02	11.77	12.88	12.93
OPEC oil exports (million b/d)	29.4	25.8	29.3	29.8	28.0
OPEC import volume (percent change)	47.0	40.0	20.0	16.0	−1.0
Net external lending by private financial institutions (billion US $)	24.9	31.8	36.1	61.8	85.1

[1] For comparability between OECD countries and the non-OPEC LDCs, all balances exclude official transfers; including them would worsen the overall OECD current account balances by $12 billion (1973) to $18 billion (1978) with most of the adjustment accruing to the United States, West Germany, and the United Kingdom. Because of rounding, components may not add to the totals shown.
[2] Excluding South Africa, Israel, Malta, and protectorates and trusts.

This table is [redacted]

[redacted]

[redacted]

Table 2

Non-Communist Countries: Current Account Shifts 1978 to 1979 [1]

	Billion US $					Percent	
	Current Account Balance 1978	Change in 1979	Due to Change in: Oil Balance	Due to Change in: Balance of Other Factors	Current Account Balance 1979	Deficit in 1979 as Share of Exports [2]	1970's Record Deficit as Share of Exports [2]
Total OECD and Non-OPEC LDCS [3]	−2.8	−55.0	−59.0	4.0	−57.8	3.6	4.8 (1974)
OECD	27.2	−42.0	−54.0	12.0	−14.8	1.0	2.0 (1974)
United States [4]	−8.8	12.2	−18.3	30.6	3.4	Surplus	5.4 (1977)
Big Six	42.9	−46.9	−26.9	−20.0	−4.0	0.5	3.2 (1974)
Japan	16.9	−24.6	−11.0	−13.6	−7.8	6.2	6.8 (1974)
West Germany	12.2	−12.7	−10.8	−2.0	−0.5	0.2	0.2 (1979)
France	5.4	−1.0	−3.6	2.6	4.4	Surplus	7.6 (1974)
United Kingdom	5.2	−5.8	2.7	−8.5	−0.7	0.5	11.3 (1974)
Italy	7.7	−2.7	−3.9	1.2	5.0	Surplus	18.4 (1974)
Canada	−4.4	0.1	−0.3	0.4	−4.4	6.8	11.8 (1975)
Smaller OECD Of which:	−6.8	−7.4	−8.8	1.4	−14.1	3.8	7.5 (1977)
Denmark	−2.0	−1.4	NEGL	−1.5	−3.4	17.0	17.0 (1979)
Greece	−1.3	−0.7	−0.8	0.1	−2.0	31.4	49.3 (1973)
Portugal	−0.7	0.3	0.4	NEGL	−0.4	9.5	51.0 (1977)
Spain	1.8	0.7	−1.9	2.6	2.5	Surplus	29.4 (1976)
Sweden	NEGL	−0.3	−1.1	0.8	−0.3	0.8	9.4 (1977)
Turkey	−1.4	−0.4	−0.3	−0.1	−1.8	64.7	133.7 (1977)
Non-OPEC LDCs Of which:	−30.0	−13.0	−5.0	−8.0	−43.0	24.8	37.4 (1975)
Non-oil-exporting LDCs Of which:	−23.0	−13.0	−10.0	−3.0	−36.0	27.3	27.3 (1979)
Argentina	2.2	−2.0	NEGL	−2.0	0.2	Surplus	43.9 (1975)
Brazil	−7.0	−2.6	−2.5	−0.1	−9.6	65.2	97.4 (1974)
Chile	−0.8	−0.1	−0.3	0.2	−0.9	26.0	76.5 (1974)
Hong Kong	−0.6	−1.2	−0.2	−1.0	−1.8	12.3	12.3 (1979)
India	0.4	−1.0	−1.4	0.4	−0.6	7.2	25.8 (1975)
Ivory Coast	−0.5	−0.6	−0.1	−0.5	−1.0	35.7	35.7 (1979)
Pakistan	−0.8	−0.7	−0.1	−0.6	−1.5	75.0	75.0 (1979)
Philippines	−1.3	−0.4	−0.6	0.2	−1.7	40.5	40.5 (1979)
South Korea	−1.2	−2.3	−1.4	−0.9	−3.5	23.2	23.2 (1979)
Taiwan	1.7	−0.9	−0.9	NEGL	0.8	Surplus	20.0 (1974)
Thailand	−1.2	−0.6	−0.8	0.2	−1.8	34.6	34.6 (1979)
OPEC	7.8	65.8	66.5	−0.7	73.6	4.8 [5]	8.9 (1974) [5]

[1] Estimated; all balances exclude official transfers. Because of rounding, components may not add to the totals shown.
[2] Exports of goods and services for OECD countries; exports of goods for non-OPEC LDCs.
[3] Excluding South Africa, Israel, Malta, and protectorates and trusts.
[4] [redacted] oil balance change is change in imports of fuels and lubricants.
[5] OPEC surplus as percent of sum of exports of goods and services of OECD countries and exports of goods of non-OPEC LDCs.

This table is [redacted]

[redacted]

[redacted]

The second important factor in avoiding financial difficulties in 1979 was the generally strong financial position with which most non-OPEC countries entered the year. The OECD countries had a combined current account surplus of $27 billion in 1978. Only Turkey was in severe financial straits; Portugal and Spain had rectified their financial difficulties of 1976-77. In the non-OPEC LDCs, the $30 billion combined deficit in 1978 had represented the first rise in three years; even so, the deficit remained below the 1975 level, particularly when measured as a percent of export earnings. Gross international reserves of the non-OPEC LDCs were at an alltime high by the end of 1978, in both value terms and as a percent of imports, after having increased by nearly $40 billion in 1976-78. (U)

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For this year, we project the OPEC current account surplus at [redacted] and the combined deficits of the OECD countries and non-OPEC LDCs at about [redacted][1] The chief reason for the deepening of this deficit will be the higher average 1980 price for OPEC oil; a slowdown in the economic growth of the major OECD countries will be the main factor in determining the distribution of the deficit. (C)

The 1980 Oil Market. World oil market conditions will be a key determinant in the 1980 world current account outlook. For this year, we expect OPEC oil prices to average [redacted] (see the figure). The projected [redacted] is based on the expectation that demand for OPEC oil exports will [redacted] this year (see table 3):

- Growth in real economic activity in the OECD countries will probably slow markedly from the 1979 pace—with overall OECD real GNP probably rising only about 1 percent, compared with 3 percent last year.

[1] The difference between the OPEC surplus and the combined deficit of the OECD countries and non-OPEC LDCs is accounted for by: (a) the current account positions of non-Communist countries not being included in these categories (South Africa, Israel, Malta, and protectorates and trusts), (b) the Communist countries' net deficit position, and (c) various statistical discrepancies which have been both large and volatile in recent years. (U)

Table 3

World Oil Market: Selected Trends [1]

	1978	1979	1980
	US $ per Barrel		
OPEC oil price	12.93	18.66	[redacted]
	Million b/d		
OECD net oil imports	25.7	26.3	[redacted]
Non-OPEC LDC net oil imports	3.0	3.0	[redacted]
Communist net oil exports	1.0	0.8	[redacted]
Other developed countries' net oil imports	0.4	0.4	[redacted]
Demand for OPEC oil exports	28.0	29.0	[redacted]

[1] Because of rounding, components may not add to the totals shown.

This table is [redacted]

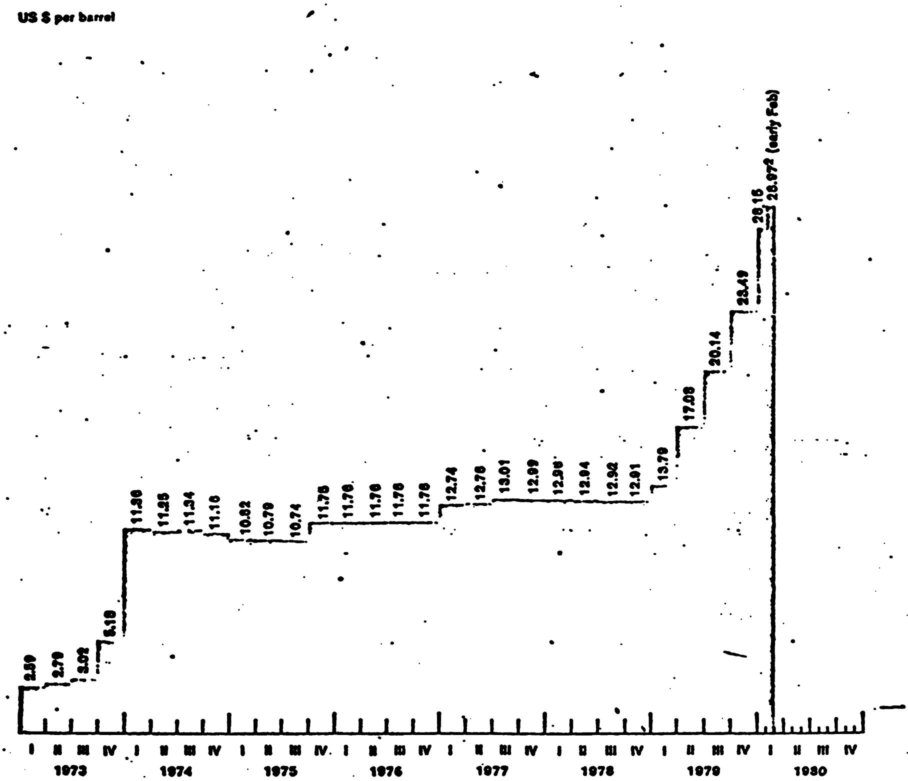
- Oil conservation, as measured by a ratio of oil consumption to real GNP, could improve substantially this year—since the large increases in world oil prices of 1979 are pushing up retail oil and energy prices, inducing increased conservation and substitution for oil products. The uncertainty created by the spot shortages of oil products in 1979 also will probably boost conservation in 1980, as will the slowing in economic growth (very slow economic growth has been associated with unusually large drops in oil to GNP ratios).

- Additions to oil stocks, which totaled about a half million barrels per day (b/d) in 1979, probably will not be repeated this year; if oil prices level off and the differential between spot and official price continues to close, some drawdown in stocks might even occur, depending in part on perceptions of political stability in the Persian Gulf region.

- The European winter appears likely to be warmer than normal this year, in marked contrast to last year's extremely cold temperatures. Harsh weather was one factor in the sharp rise in European oil consumption and imports in 1979. [redacted]

[redacted]

OPEC: Average Crude Oil Official Sales Price[1]



[1]Pre-1974 prices are derived from posted prices and are not official sales prices.

[2]Including estimates for some countries and increases announced as of 5 Feb 1980.

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[redacted]

We expect overall oil demand in the non-OPEC countries [redacted] from that of 1979. A probable increase of 0.5 million b/d oil equivalent in the production of energy from nonoil sources—mostly coal, natural gas, and nuclear power in the United States and Western Europe—will replace an equivalent amount of oil, particularly fuel oil, and [redacted]

OPEC Current Accounts in 1980. [redacted] in 1978 (see table 4).[3] Including official transfers, these surpluses would be [redacted] respectively. A record level in

[3] For a detailed discussion of the OPEC current account outlook, see *OPEC: The 1980 Current Account Surplus and Its Placement*, ER 80-10131, February 1980, S NF NC OC. (U)

Table 4

OPEC: Current Account Trends [1]

	1978	1979	1980
	Billion US $		
Exports of goods	140.3	208.1	[redacted]
Oil	129.7	196.2	[redacted]
Nonoil	10.7	11.8	[redacted]
Imports of goods	100.3	104.1	[redacted]
Net service and private transfers	−32.3	−30.4	[redacted]
Current account balance	7.8	73.6	[redacted]
Memoranda			
Net official transfers	3.4	4.5	[redacted]
	Percent		
Change in import volume	−1.0	−9.0	[redacted]

[1] Because of rounding, components may not add to the totals shown.

This table is [redacted]

nominal terms, the 1980 surplus would still be below the 1974 mark when measured as a share of the exports of goods and services in the non-OPEC countries. [redacted]

Despite the much larger jump in average price per barrel of oil in 1980—[redacted] compared with a $5.73 hike in 1979—[redacted] One key factor in this judgment is our projection that OPEC oil exports will [redacted] this year, instead of rising by 1 million b/d as they did in 1979. Slower OECD economic growth, increased oil conservation, and higher non-OPEC oil supplies all should play a role in this outcome. [redacted]

In addition, OPEC import volume [redacted] this year, compared with [redacted] in 1979. We do not, however, expect anything close to a repeat of the 1974 expansion, when OPEC countries increased their purchases of foreign goods by 47 percent in real terms. The import base has grown

[redacted]

[redacted]

much larger in the interim, making a slowdown in percentage rates of growth almost inevitable. OPEC's 1973 import base was about $20 billion, whereas the estimated 1979 figure is $104 billion. In addition, the views of several important OPEC countries toward the desired pace of economic development have changed markedly, most notably in [redacted]

The aggregate OPEC surplus will, of course, be unevenly allocated among the member states. The distribution will be determined by oil price structure and production levels as well as by the pace of domestic development programs. Only [redacted]—will account for [redacted] of the total OPEC surplus. Saudi Arabia will post the largest individual surplus [redacted] followed by [redacted]

Current Accounts of Non-OPEC Countries in 1980. Chiefly as a result of the higher OPEC oil prices, we expect the current accounts of the OECD countries and the non-OPEC LDCs to deteriorate as much this year as they did in 1979. For these countries as a group, we foresee a 1980 current account deficit before official transfers of [redacted] compared with a $58 billion deficit in 1979 and a $3 billion deficit in 1978 (see table 5). [redacted]

OECD Countries. In the developed countries, we expect the total 1980 deficit to balloon to nearly [redacted] than in 1979. The deterioration in the OECD's combined oil balance adds [redacted] to the expected deficit. We expect the overall deterioration to be held to less than [redacted] by an improvement in the nonoil trade balance in the OECD countries. Their real economic and import growth will probably slow substantially; export gains to the non-OPEC LDCs will slacken also, but not by as much; and sales to OPEC will rise for the first time in three years. [redacted]

[redacted]

[redacted]

[redacted]

Table 5

Non-Communist Countries: Current Account Shifts 1979 to 1980[1]

	Billion US $					Percent	
	Current Account Balance 1979	Change in 1980	Due to Change in: Oil Balance[4]	Due to Change in: Balance of Other Factors	Current Account Balance 1980	Deficit in 1980 as Share of Exports[2]	1970's Record Deficit as Share of Exports[2]
Total OECD and Non-OPEC LDCs[3]	−57.8	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	4.8 (1974)
OECD	−14.5	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	2.0 (1974)
United States[4]	3.4	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	5.4 (1977)
Big Six	−4.0	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	3.2 (1974)
Japan	−7.8	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	6.8 (1974)
West Germany	−0.5	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	0.2 (1979)
France	4.4	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	7.6 (1974)
United Kingdom	−0.7	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	11.3 (1974)
Italy	5.0	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	18.4 (1974)
Canada	−4.4	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	11.8 (1975)
Smaller OECD Of which:	−14.1	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	7.9 (1977)
Denmark	−3.4	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	17.0 (1979)
Greece	−2.0	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	49.3 (1973)
Portugal	−0.4	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	51.0 (1977)
Spain	2.5	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	29.4 (1977)
Sweden	−0.3	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	9.4 (1977)
Turkey	−1.8	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	133.7 (1977)
Non-OPEC LDCs Of which:	−43.0	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	37.4 (1975)
Non-oil-exporting LDCs Of which:	−36.0	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	27.3 (1979)
Argentina	0.2	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	43.9 (1975)
Brazil	−9.6	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	97.4 (1974)
Chile	−0.9	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	76.5 (1974)
Hong Kong	−1.8	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	12.3 (1979)
India	−0.6	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	25.8 (1975)
Ivory Coast	−1.0	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	35.7 (1979)
Pakistan	−1.5	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	75.0 (1979)
Philippines	−1.7	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	40.5 (1979)
South Korea	−3.5	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	23.2 (1979)
Taiwan	0.8	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	20.0 (1974)
Thailand	−1.8	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	34.6 (1979)
OPEC	73.6	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	8.9 (1974)[5]

[1] Projected; all balances exclude official transfers. Because of rounding, components may not add to the totals shown.
[2] Exports of goods and services for OECD countries; exports of goods for non-OPEC LDCs.
[3] Excluding South Africa, Israel, Malta, and protectorates and trusts.
[redacted]; oil balance change is change in imports of fuels and lubricants.
[5] OPEC surplus as percent of the sum of the exports of goods and services of the OECD countries and the exports of goods of the non-OPEC LDCs.

This table is [redacted]

[redacted]

[redacted]

[redacted]

[redacted] This aggregate deficit would be larger in nominal terms than the record deficit of 1977 for these countries, but would be smaller as a share of their exports. [redacted]

Some of these countries may be running current account deficits this year large enough to be of concern to their own governments or to potential financiers of the deficits. [redacted]—largely due to a cumulative $10 billion in current account deficits since the 1973/74 OPEC oil price rise. Its expected uncovered financial gap of [redacted] for this year will probably be largely financed by sizable increases in Western aid flows aimed at [redacted] In addition, the [redacted] has begun to implement a program approved by the IMF (International Monetary Fund) to deal with the economic crisis. In view of the fragile political balance, however, it is problematic whether the program can succeed. [redacted]

Non-OPEC and Non-Oil-Exporting LDCs. We currently project the combined current account deficit of the non-OPEC LDCs for 1980 at about $55 billion, up from an estimated $43 billion last year. Although this deficit in nominal terms will be by far the largest ever incurred by the non-OPEC LDCs, it will still be well below the 1975 deficit as a percent of exports.

In contrast to the situation occurring in the OECD countries, increased oil payments are not the chief cause of the rise in the deficit—since the non-OPEC LDCs include several countries that are producing increasing amounts of oil. We anticipate only about a [redacted], compared with $5 billion in 1979.

If we focus on the non-oil-exporting countries in this group, however, shifts in oil balances become much more important. For these countries—the non-OPEC LDCs [redacted]—we currently project a 1980 current account deficit of [redacted] Worsened oil balances are forecast to account for [redacted] of the deterioration.

The current account deficits of both the oil-exporting and non-oil-exporting LDCs are expected to worsen as a result of factors other than oil. Slower OECD real growth will cut the increases in LDC export earnings, barring an unforeseen speculative runup in commodity prices. [redacted] these countries are expected to have economic growth at roughly [redacted] percent in 1980, compared with a 6.3 percent average in 1970-77.

[redacted]

The nonoil LDCs probably will try to hold oil imports constant, as they did in 1974-75, while taking whatever real import growth is possible in capital equipment and raw materials. Thus, trade balances in nonoil items in the nonoil LDCs as well as the oil-producing LDCs probably will worsen slightly. The overall deficit of nonoil LDCs will also be pushed up [redacted] by the increased interest payments that non-OPEC LDCs will have to make as a result of their increasing debt and the sharp rise in international interest rates. [redacted]

[redacted]

The Current Account Outlook Beyond 1980

[redacted]

[redacted]

[redacted]

Clearly, some of these assumptions or expectations will not turn out exactly as projected. [redacted]

Distribution of Deficits: A Possible Scenario. The distribution of current account deficits in 1981 associated with a [redacted] OPEC surplus is difficult to project at this point. Differential growth and inflation rates, relative competitiveness, changes in market shares, and government policies all will play a role in determining the allocation of the deficits. In 1974-78, for example, despite [redacted] in cumulative OPEC surpluses [redacted] posted cumulative surpluses that totaled [redacted] and the cumulative current account balances of other individual non-OPEC countries varied widely. [redacted]

Although country-by-country projections of current account balances in 1981 are premature, we can outline a possible distribution of the deficits. First, it seems probable that any decline in the OPEC surplus would be captured by export-oriented countries already having a large share of the OPEC market; this suggests that [redacted] could reduce their deficits in 1981. Second, to the extent that much of OPEC's increased imports are captured by [redacted]

Financial Implications and Possible Reactions. Most likely, the 1980 deficits will be financed without too much difficulty. [redacted]

If past patterns are followed, [redacted]

The variety of assets and present high interest rates available [redacted] will ensure petrodollar inflows [redacted]

On the non-OPEC side, a large portion of the 1980 deficits will be concentrated in countries that should easily be able to obtain financing. Even [redacted] and [redacted] in the nonoil group of LDCs will probably be able to obtain private funding for their deficits, and ample private-source funds should be available for most other high-income LDCs. [redacted]

[redacted]

[redacted]

Table 6 [redacted]

[redacted]

This table i[redacted]

LDCs of low income and lower middle income will probably be able to tap official and multilateral sources of funds to finance their current account deficits. Bilateral grants from the OECD will be affected by [redacted] in these countries, but we nevertheless expect total OECD official transfers, including those to international organizations, to [redacted] level by next year. As a result of Third World pressures, [redacted]

The relevan[redacted] seem to be in an improved position to take a larger share of the financing load through grants, concessionary loans, and development-oriented flows. [redacted] Still, some lower income LDCs

[redacted]

Aside from [redacted] the most critical 1980 financing questions will apply to the [redacted] some of which have only recently begun to appear regularly in private credit markets. These LDCs, as a result of their level of development, are not high-priority recipients of official loans. Certain middle-income LDCs [redacted] for example—still have good access to the private capital markets; the [redacted] recently negotiated a $200 million credit with a spread of only 0.75 percentage point above the London Inter-Bank Offer Rate (LIBOR). Middle-income LDCs with little or no exposure to private sources of funds, on the other hand, [redacted] Incl this group are [redacted]

[redacted]

In general, the high level of liquidity resulting from the huge OPEC surplus will [redacted]. Even so, some affected LDC governments will be increasingly wary of adding to high debt service ratios. This will be especially true if there is a widening in the spreads from the already high LIBOR fixings that non-OPEC LDCs face in international financial markets. In this situation, [redacted]

The Longer Run Outlook. It is in 1981 that the strain on the international financial system will become more severe. By yearend 1981, the OECD countries and the non-OPEC LDCs will have added more than [redacted] to their international indebtedness in a three-year timespan, [redacted] Moreover, this large increase in international debt will be occurring at a time when already [redacted]

[redacted] Debt service payments by non-OPEC LDCs on medium- and long-term debt are expected to reach [redacted] this year and go up even more in 1981. Heavy borrowing in the last three years has created [redacted] Non-OPEC LDC interest payments on outstanding debt owed to private institutions are expected [redacted] As recently as 1978, the average interest cost for private bank debt was 8.5 percent. In a vicious circle, the larger share of LDC debt [redacted] now carries higher service payments as interest rates escalate. [redacted]

Table 7 Billion US $

Non-OPEC LDCs: External Financing

	1978	1979	1980[1]
Uses of external financing	[redacted]	[redacted]	[redacted]
Current account deficit (goods, services, and private transfers)	[redacted]	[redacted]	[redacted]
Less: official net transfers to LDCs	[redacted]	[redacted]	[redacted]
Current account deficit (goods, services, and private and official transfers	[redacted]	[redacted]	[redacted]
Amortization of medium- and long-term external debt	[redacted]	[redacted]	[redacted]
Change in international reserves	[redacted]	[redacted]	[redacted]
Sources of external financing	[redacted]	[redacted]	[redacted]
Direct investment, net	[redacted]	[redacted]	[redacted]
Medium- and long-term borrowing (gross)	[redacted]	[redacted]	[redacted]
Medium- and long-term borrowing (net)	[redacted]	[redacted]	[redacted]
Other capital, net[3]	[redacted]	[redacted]	[redacted]

[1] Projected.
[2] Assumes financial policies on the part of the LDCs that equate to maintenance of the equivalent of three months' imports in foreign exchange reserves.
[3] Including residual errors.

This table is [redacted]

In addition to LDC debt problems, a number of other developments will continue to cause concern about how international capital markets will function in recycling surplus OPEC oil revenues [redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

In order to provide as smooth an adjustment as possible to the recent runup in oil prices [redacted] The bulk of the additional concessional or grant aid needed by [redacted] may have to come from [redacted]

[redacted]

We expect adjustment to be greatest among the [redacted] The first two groups will see [redacted] Most of them will probably be able to attract enough funds to [redacted]

[redacted] [redacted]

KUWAIT: Awash With Oil Money

[redacted]

Recent and prospective oil price increases will lead to record budget and current account surpluses in Kuwait [redacted]. In a similar situation at the time of the 1973-74 oil price hikes, the government brushed aside visions of industrial grandeur in favor of moderate economic growth, prudent foreign investments, and reduced oil production. [redacted]

Kuwait was already one of the most affluent and economically developed members of OPEC at the time of the 1973-74 oil price hikes. Since then, a large part of its enormous financial inflows has gone to extend one of the most advanced welfare states in the world. Profiting from past mistakes, Kuwait restrained government spending for industrialization and hence has suffered fewer economic and social dislocations than other Persian Gulf oil producers did in the late 1970s. (U)

The fiscal year 1980 budget approved this summer demonstrates continued government interest in restraining spending, especially for industrial projects. Planned outlays of slightly more than $8 billion are only 16 percent above those in the previous budget. If inflation remains in last year's range, [redacted] government spending will show little real growth. Less than 2 percent is slated for development, and no plans for major industrial projects are on the books. [redacted]

The government projects revenues to increase 40 percent, to $11.7 billion--[redacted] If the current high level of oil production continues through the fiscal year, oil revenues alone should be about $19 billion because of the oil price increases last month and the large volumes of oil being sold at spot

--continued

[redacted] [redacted]

6 September 1979

[redacted]

[redacted]

market prices. [redacted]

Kuwait does not have a planned economy, and the government probably has no program for spending the huge revenues that will be coming in for the foreseeable future. Although the Ministry of Planning, with assistance from the World Bank, is beginning work on a program for 1981-85, the government is reluctant to commit itself to a long-term plan. [redacted]

In the absence of any official development plan, no dramatic increase in spending is likely. Now that a $1 billion liquefied petroleum gas complex has been completed, an upgrading of gasoline production capacity is the only large hydrocarbon-based project still on the books. Other ambitious projects such as steel mills have apparently been shelved permanently. [redacted]

Restraint in industrial growth appears to have widespread support. Kuwaitis do not want industrial projects that would require more foreign labor; expatriates already comprise 53 percent of the population and 70 percent of the labor force. Kuwaitis also are reluctant to approve projects that could damage the environment. Most important, the sophisticated and well-traveled Kuwaitis have come to appreciate investments--whether at home or abroad--for their economic viability rather than their prestige. (U)

Given social, manpower, and environmental constraints, Kuwait [redacted] maintained since the 1973-74 oil price hikes. [redacted] The government now requires that 10 percent of revenues be put into a Future Generations Reserve Fund, which is invested abroad. Income from these investments is retained by the Fund and cannot be drawn for budgetary use for at least 25 years. [redacted]

--continued

[redacted]

6 November 1979

[redacted]

[redacted]

Despite some economic diversification and [redacted], Kuwait will still have a one-commodity economy for the immediate future. Oil contributes 75 percent of GDP, more than 80 percent of government revenues, and almost all export earnings. In an attempt to stretch out oil reserves for future generations Kuwait in 1975 imposed a ceiling on output of 2 million barrels per day (not counting 300,000 barrels per day from the Neutral Zone). Oil production from Kuwait proper had been about 2.7 million barrels per day in 1973. [redacted]

The government is likely to bring output from its current level of about 2.2 million barrels per day down to the ceiling of 2 million barrels per day this year, and it has stated its intention of lowering the ceiling to 1.5 million barrels per day some time before 1985. [redacted]

[redacted]

6 November 1979

[redacted] [redacted]

[redacted]

OPEC Countries: Annual Report On Official Foreign Assets (U)

A Research Paper

Research for this report was completed on 16 November 1979.

[redacted]

9 DECEMBER 1981

[redacted]

February 1980

[redacted]

Preface

[redacted]

In this fifth annual report on OPEC foreign official assets, we have examined trends in OPEC investment in 1978, noting the size, composition, and location of new and existing placements. The data establish a baseline from which developments in 1979 and 1980 can be judged. Interim reports on the status of OPEC assets will appear in the *Economic Intelligence Weekly Review*, published by the Office of Economic Research. (U)

[redacted]

[redacted]

OPEC Countries: Annual Report On Official Foreign Assets (U)

Overview

[redacted]

[redacted]

OPEC Countries: Annual Report On Official Foreign Assets (U)

Investment Levels

Table 1

Billion US

OPEC Countries:
Estimated Investable Surplus

[redacted]

Table 2 | Million US $

OPEC Countries:
Official Foreign Assets, Yearend [1]

[redacted]

Table 3

Million US

OPEC Countries:
Change in Official Foreign Assets, 1978 [1]

3

Table 4	Percent of Total

OPEC Countries: Official Foreign Assets, by Type [1]
31 December 1978

Table 5	Percent of Total

OPEC Countries: Official Foreign Assets, by Currency [1], 31 December 1978

[redacted]

Table 6

Million US $

OPEC Countries: Location of Official Foreign Assets, Yearend 1978

5 [redacted]

[redacted]

Location of Assets

[redacted]

Current and Capital Accounts

Reconciliation of current and capital accounts for OPEC countries requires examination of private transactions as well as official transactions other than asset accumulation. The task is complicated by (1) definitional problems, (2) timing problems, and (3) gaps in the availability of data: Since some inconsistencies cannot be resolved, an errors and omissions category is necessary.

7

[redacted]

* * * * *

OPEC: CHAFING UNDER LDC CRITICISM (U)

[redacted]. While the debate within OPEC over assistance to developing countries continues, there is little support within the cartel for a large-scale effort. [redacted]

The Impact of Oil Prices on Developing Countries

Oil-importing LDCs have been hard hit by sharply higher oil import costs. The current account deficit of LDCs that are not members of the Organization of Petroleum Exporting Countries (OPEC)—after remaining relatively constant in 1975-78—rose from $23 billion in 1978 to $35 billion last year. The increase reflected:

[redacted]

- The direct impact of increased oil prices, which added $10 billion to the LDC deficit.

- The indirect impact of slower growth and higher inflation in industrialized countries, which lowered demand for LDC exports and raised prices of many of the goods the LDCs import. [redacted]

LDC Criticism

The increase in LDC criticism of OPEC partly reflects the oil cartel's limited effort in the past to relieve the oil import burdens of most non-OPEC LDCs. Although in 1974-78 OPEC donors disbursed $25 billion in economic aid—both bilateral and through international financial institutions—most of the aid went to Arab and non-Arab Muslim states. Some of these recipients are net oil exporters. Moreover, annual OPEC aid actually declined in 1978 because political relations with Egypt, a prime recipient in 1974-77, deteriorated. (U)

The LDCs demanded massive increases in OPEC development aid, bilateral grants to offset higher oil charges, guaranteed oil supplies, and, perhaps most important, the offering of OPEC oil at lower prices to LDCs than to industrialized nations. [redacted]

OPEC Response

Some OPEC members were concerned enough about the criticism that surfaced to take limited action last year. [redacted] has received at least half this amount. [redacted] subsidizes the oil it sells to its Caribbean neighbors by granting $6.00-per-barrel rebates in the form of soft loans. [redacted] No OPEC member is giving major price breaks to LDCs. [redacted]

OPEC Concerns

OPEC members hold sharply disparate attitudes on whether and how to deal with the demands of LDCs. Among those that support additional aid initiatives are:

- A few OPEC countries—for example, [redacted]—that believe continued criticism from other LDCs could undermine unity within the Group of 77 and isolate the cartel.

- Several OPEC members—notably [redacted]—that probably believe the criticism could jeopardize their ambitions to lead the LDC caucus.

[redacted]

- Others, such as [redacted] that believe new efforts by OPEC could reduce bilateral pressure for aid from LDCs within their regions. [redacted]

Some cartel members—[redacted]—oppose a multilateral aid effort, arguing that aid should remain a bilateral concern, and that oil prices and aid should not be linked. [redacted] for example, is only lukewarm toward the idea of increasing contributions to multilateral funds. [redacted]

The Caracas Meeting

Largely through the efforts of [redacted], a moderate member, and a leading advocate of new initiatives to aid LDC oil importers—the issue of OPEC aid to LDCs was placed on the agenda for the December 1979 OPEC meeting in Caracas. Specifically, [redacted]

Mainly because OPEC could not reach agreement on unified oil prices, the final communique stressed the cartel's efforts to aid oil-importing LDCs. The cartel's members boosted contributions to the OPEC Special Fund by $1.6 billion, to a total of $4 billion, and agreed in principle to convert the Fund into a Development Bank. OPEC also pledged to give priority to supplying developing countries with oil for domestic use at the official prices charged by individual members. (U)

Little Benefit to LDCs

Despite extensive publicity heralding these measures as a major OPEC effort, the net gain for oil-importing developing countries will be small. Moreover, the plans may not be fully implemented. Although the Special Fund increase is double the contribution from the June 1979 OPEC meeting, it will not provide substantial near-term balance-of-payments relief. OPEC Finance Ministers waited until January 1980 to discuss allocating the funds promised at the June 1979 meeting and [redacted]

OPEC's pledge to give LDCs priority of supply at official prices will help those LDCs who purchase oil at the spot market price. Nonetheless, the LDC oil bill will increase. More importantly, [redacted]

Outlook

The OPEC ministers may meet again this spring in special session to discuss crude

[redacted]

[redacted]

oil pricing and to reexamine the supply situation. Although it is unlikely that relations with developing countries will be on the agenda. [redacted]

OPEC's relations with oil-importing LDCs [redacted] Criticism of OPEC by developing countries is already spilling over into multilateral forums. [redacted] If the Group of 77 is unable to present developed countries with a unified position, progress in any North-South forum will be virtually impossible. ([redacted]

At the same time, OPEC reluctance to offer significant group assistance to oil-importing LDCs improves the relative position within the LDC caucus of those OPEC nations—[redacted]—that appear to take LDC concerns seriously. [redacted]

[redacted]

* * * * * *

OPEC: THE 1980 CURRENT ACCOUNT SURPLUS AND ITS PLACEMENT * (U)

Soaring revenues, combined with relatively slow growth in imports, seem likely to drive this year's OPEC current account surplus to [redacted] following an estimated [redacted] surplus in 1979. While nominally [redacted] reached in 1974, [redacted] when allowance is made for inflation and growth in the world economy. For instance, the 1974 OPEC surplus amounted to about 1.8 percent of the then nominal OECD GNP of $3.6 trillion; [redacted]. As in 1974, the surplus will be concentrated among the largest Persian Gulf producers [redacted] should account for [redacted] and [redacted], and [redacted] together for another [redacted] percent. [redacted]

[redacted] such a move will be tempered by interest rate and exchange rate considerations as well as by the availability of investment instruments. [redacted]

OPEC: Current Account Balances

Billion US $

	1974	1975	1976	1977	1978	1979 [1]	[redacted]
Trade balance	80.4	49.4	61.1	57.7	40.1	104.0	[redacted]
Exports (f.o.b.)	118.2	107.9	131.4	146.4	140.3	208.1	[redacted]
Oil	111.6	101.6	123.5	137.1	129.7	196.2	[redacted]
Nonoil	6.5	6.4	7.9	9.3	10.7	11.8	[redacted]
Imports (f.o.b.)	37.7	58.5	70.3	83.7	100.3	104.1	[redacted]
Net services and private transfers	[redacted]						
Freight and insurance	−4.5	−8.1	−10.8	−12.1	−13.6	−14.0	[redacted]
Investment income receipts	[redacted]						
Other	−8.7	−12.5	−18.3	−24.0	−29.9	−32.5	[redacted]
Grants	[redacted]						
Current account balance	66.2	30.1	35.1	25.6	4.4	69.1	[redacted]

[1] Estimated.
[2] Projected.

[redacted]

* This article summarizes a forthcoming OER intelligence assessment. (U)

[redacted]

Unlike the 1974-78 experience, when the OPEC surplus surged in the first year following the big oil price increases and then dwindled to less than $5 billion in the ensuing four years, [redacted] instance, if OECD growth recovers to 2.5 percent in 1981 [redacted], the OPEC surplus would [redacted] Lower growth would reduce this figure, whereas substantial supply disruptions resulting in a further increase in the real OPEC oil price would raise it. [redacted]

OPEC Export Earnings

Official OPEC prices now average $29 per barrel; spot market premiums, $10 or higher in mid-1979, have largely disappeared. Discrepancies persist, however, among official prices for competitive types of crude produced in different countries, [redacted]

Higher prices and increased non-OPEC energy supplies, combined with much slower growth [redacted], should reduce non-OPEC demand for OPEC oil by about [redacted] b/d below last year's 29.0 million b/d. [redacted]

After allowing for transfers of oil under equity and buy-back arrangements, we expect the average price realized by OPEC producers [redacted].

Nonoil OPEC exports are expected to rise from $11.8 billion in 1979 to $14.6 billion in 1980, falling as a share of total export revenues from 5.7 percent last year to about 5 percent this year. Indonesia, which accounts for nearly half of the total, should benefit from strong demand for its wood, rubber, tin, and coffee (U)

Imports

In 1974, the value of OPEC merchandise imports jumped by 84 percent; in 1980 it is expected to increase by [redacted] The import base has grown much larger in the interim, making a slowdown in percentage rates of growth almost inevitable; the 1973 import base was about $20 billion, whereas the estimated 1979 figure is $104 billion. In addition, several important OPEC countries have undergone a marked change in views toward the desired pace of economic development [redacted]

[redacted]

Events in Iran, moreover, have been interpreted prophetically in other Middle Eastern OPEC countries which have seen their traditional social values threatened by modernization programs and have experienced distribution bottlenecks, accelerated inflation, increased exposures to foreign influence, widened income disparities, and expanding corruption. Their response is to hold a tight rein on spending, despite enormous revenue increases. The notable exception in the Persian Gulf to the policy of slowed import growth is Iraq, which is scheduled to receive [redacted]

Net Services, Private Transfers, and Grants

Net services and private transfers—an important negative item in the OPEC current account—are expected to rise 21 percent this year, considerably more slowly than in the years immediately following the 1973/74 price hikes. Two factors are primarily responsible for the lower rate: (a) [redacted] and (b) [redacted]

In 1974-79, member states of OPEC disbursed [redacted] in bilateral grants, ([redacted] in 1979 alone). [redacted] in the period, with grants of [redacted] billion, or [redacted] percent of the total. OPEC grant aid is [redacted] because the donors will be awash with funds and the oil price increases will have intensified the need of recipients. The pattern of distribution among donors and beneficiaries should change in response to political circumstances, the most prominent case being [redacted]

Placement of the Surplus

[redacted]

 [redacted]

[redacted]

[redacted] The variety of assets and present high interest rates available in US financial markets should [redacted]

The Outlook for 1981 and Beyond

Other 1981 scenarios are also plausible. Economic recovery in the industrial countries might well be slower than expected; [redacted] OECD growth near 1.5 percent is a distinct possibility since governments may well react to inflation and payments problems this year with more restrictive economic policy. Alternatively, further [redacted]

One percentage point slower OECD growth in 1981, with OPEC maintaining a [redacted] would reduce demand for OPEC oil by [redacted] This would cut OPEC oil revenues by ~~about $0 billion,~~ resulting in an OPEC surplus of a little over [redacted]. If, however, OECD growth were forced down from a 2.5-percent rate [redacted] the net effect would be [redacted] even though [redacted] We estimate that a [redacted] for instance, would [redacted] in the industrial countries and [redacted] This would lead to [redacted] depending on how much additional [redacted]

• • • • •

[redacted]

INTERNATIONAL PAYMENTS IMPLICATIONS OF RISING OPEC OIL PRICES * (U)

The steep rise in OPEC oil prices since late 1978—from $12.91 to about $29 per barrel as of mid-February 1980—sharply worsened the 1979 current account balances of the OECD countries and non-OPEC LDCs and has paved the way for a record deficit in 1980. We put last year's combined deficit for these countries at $58 billion (excluding official transfers) and project the 1980 deficit [redacted] Very slow world economic growth in 1981 could somewhat ease the payments pressures, while more-than-moderate oil price increases would worsen the imbalances. [redacted] wp

Review of 1974-78

In 1974 the OECD and non-OPEC LDC current account positions shot to a deficit of $38 billion, excluding official transfers. Over the next four years, however, the combined shortfall decreased rather steadily, dropping to only $3 billion in 1978. Several factors contributed to this decline. Most notably, OPEC oil prices rose a total of only 14 percent in nominal terms between 1974 and 1978 while the volume of OPEC imports increased 93 percent. (U)

The 1979 Reversal

Last year, the steep rise in OPEC oil prices—to $18.66 per barrel for 1979 from $12.93 per barrel for 1978—led to a sharp turnaround in these trends. From the $3 billion deficit of 1978, the combined deficit of the non-OPEC countries rose to $58 billion last year. Much of the deterioration was concentrated in Big Seven OECD countries able to withstand worsened current account positions. Of the $55 billion total current account deterioration, Japan accounted for $25 billion, West Germany for $13 billion, and the United Kingdom for $6 billion. In 1979 the worsening in the payments positions of the smaller OECD countries and the non-OPEC LDCs totaled only about $20 billion. (U)

Some countries improved their current account positions in 1979 the higher oil prices. The United States posted the largest improvement. The lagged effects of dollar depreciation in 1978 and the slowdown in US real growth relative to the growth of its trading partners led to an improvement in the US nonoil balance that overrode the worsened US oil balance. (U)

The 1980 Outlook

Chiefly as a result of higher OPEC prices—[redacted] per barrel compared with $18.66 in 1979—[redacted]

* This article is based on a recent [redacted] Assessment of the same title. (U)

[redacted]

OECD and Non-OPEC LDCs: Current Account Balances and Shifts [1]

Billion US $

	Current Account Balance 1978	Change in 1979: Oil Balance	Change in 1979: Balance of Other Factors	Current Account Balance 1979	Change in 1980
Total [2]	−2.8	−59.0	4.0	−57.8	
OECD	27.2	−54.0	12.0	−14.8	
United States [3]	−6.8	−15.3	30.6	3.4	
Big Six	42.9	−26.9	−20.0	−4.0	
Japan	16.9	−11.0	−13.7	−7.8	
West Germany	12.2	−10.6	−2.0	−0.5	
France	5.4	−3.6	2.6	4.4	
United Kingdom	5.2	2.7	−8.5	−0.7	
Italy	7.7	−3.9	1.2	5.0	
Canada	−4.4	−0.3	0.4	−4.4	
Smaller OECD	−6.8	−8.8	1.4	−14.1	
Of which:					
Denmark	−2.0	Negl	−1.5	−3.4	
Greece	−1.3	−0.8	0.1	−2.0	
Portugal	−0.7	0.4	Negl	−0.4	
Spain	1.8	−1.9	2.6	2.5	
Sweden	Negl	−1.1	0.8	−0.3	
Turkey	−1.4	−0.3	−0.1	−1.8	
Non-OPEC LDCs	−30.0	−5.0	−8.0	−43.0	
Of which:					
Non oil-exporting LDCs	−23.0	−10.0	−3.0	−36.0	
Of which:					
Argentina	2.2	Negl	−2.0	0.2	
Brazil	−7.0	−2.5	−0.1	−9.6	
Chile	−0.8	−0.3	0.2	−0.9	
Hong Kong	−0.6	−0.2	−1.0	−1.8	
India	0.4	−1.4	0.4	−0.6	
Ivory Coast	−0.5	−0.1	−0.5	−1.0	
Pakistan	−0.8	−0.1	−0.6	−1.5	
Philippines	−1.3	−0.6	0.2	−1.7	
South Korea	−1.2	−1.4	−0.9	−3.5	
Taiwan	1.7	−0.9	Negl	0.8	
Thailand	−1.2	−0.8	0.2	−1.8	

[1] Data for 1979 are estimated, and data for 1980 are projected. All balances exclude official transfers.
[2] The difference between the aggregate deficit of these countries and the OPEC surplus shown in the EIWR article, "OPEC: The 1980 Current Account Surplus and Its Placement," 22 February 1980, pp. 11-14, is accounted for by the current account position of the excluded non-Communist countries (Israel, South Africa, Malta, and protectorates and trusts), the Communist countries' net deficit position, and various statistical discrepancies which have been both large and volatile in recent years.
[redacted] Oil balance change is change in imports of fuels and lubricants.

[redacted]

[redacted] The oil balances will worsen even more than last year as a result of the larger oil price rise (expected at $11.34 per barrel this year versus the $5.73 experienced last year); the overall deterioration will be held down in part by an expected [redacted] in OPEC import volume compared with a 9-percent decline in 1979. If the worsening in the

[redacted]

combined deficit of these countries is as great as we expect, the [redacted]

OECD Countries

We expect the 1980 current account deficit of the developed countries [redacted] The deterioration in the OECD combined oil balance should add [redacted] to the projected deficit. We expect the overall deterioration to be held to less than [redacted] by [redacted] in the OECD nonoil trade balance. The expected 1980 slowdown in OECD real GNP growth to about [redacted] will markedly slow the increases in OECD import volume from last year's 7-percent rise. Concurrently, gains in exports to the non-OPEC LDCs will also slacken, but probably not by as much; and sales to OPEC will rise in real terms for the first time in three years, adding about [redacted] to OECD export receipts. [redacted]

[redacted]

[redacted] This imbalance would be larger in nominal terms than the record shortfall for this group in 1977, but, as a share of their exports, it would be smaller. [redacted]

Non-OPEC and Nonoil-Exporting LDCs

The combined current account deficit of the non-OPEC LDCs will [redacted] Although this deficit in nominal terms will be by far the largest ever incurred by the non-OPEC LDCs, it will still be well below the 1975 shortfall as a percent of exports. [redacted]

In contrast to the OECD countries, increased oil payments are not the chief cause of the rise in the deficit, as this group includes several countries that are oil producers [redacted] We anticipate only about [redacted]

Focusing on the nonoil-exporting countries in this group, however, identifies some important shifts in oil balances. For these countries, we currently project a 1980 current account deficit of [redacted], a rise of [redacted] from 1979. Worsened oil balances are forecast to account for [redacted] of the deterioration. [redacted]

The current account deficits of the non-OPEC LDCs are expected to worsen as a result of nonoil factors as well. Slower OECD real growth will cut the increases in LDC export earnings, barring an unforeseen speculative runup in commodity prices. [redacted] these countries should grow at roughly [redacted] in 1980, compared with a 6.3-percent average in 1970-77. [redacted]

The nonoil-exporting LDCs probably will try to hold oil imports constant, as they did in 1974-75, and to take whatever real import growth is possible in capital equipment and raw materials. Thus, the nonoil trade balance of these countries as well

[redacted]

as the oil-producing LDCs probably will worsen slightly; the overall nonoil deficit will also be pushed up [redacted] by the increased interest payments the non-OPEC LDCs will have to make because of their increasing debt and the jump in international interest rates. Among individual nonoil-exporting LDCs, the largest deficits this year almost certainly will be posted by [redacted]

The Current Account Outlook Beyond 1980

[redacted]

The distribution of 1981 oil-consuming country deficits associated with [redacted] would be difficult to project at this point. Differential growth and inflation rates, relative competitiveness, changes in market shares, and government policies all will play a role in determining the allocation of the deficits. In 1974-78, for example, despite $182 billion in cumulative OPEC surpluses, [redacted] posted cumulative surpluses that totaled [redacted] the cumulative current balances of other individual oil-consuming countries varied widely. [redacted]

Although country-by-country projections of current account balances in 1981 are premature, we can outline how the deficits might be distributed. First, it seems probable that any declines in the OPEC surplus would be captured by export-oriented countries already having a large share of the OPEC market; this suggests that [redacted] could reduce their deficits in 1981. Second, to the extent that much of OPEC's increased imports are captured by a [redacted]

The Recycling Problem

In our view, the recycling of the 1980 OPEC surplus, which we project at US [redacted],* can be carried out with only moderate difficulty. [redacted]

* All current account balances are expressed net of official transfers. We estimate the OPEC surplus [redacted]

[redacted]

Of the more than [redacted] in the current account deficit projected for the non-OPEC countries between 1978 and 1980, about [redacted] is expected to be absorbed by [redacted] and [redacted] In addition, certain individual countries [redacted] have already altered economic policies to forestall potential financial difficulties. [redacted]

[Remainder of Page Deleted]

[redacted]

19 March 1980

OPEC: OFFICIAL FOREIGN ASSETS MOUNT RAPIDLY (U

25 April 1980

25 April 1980

25 April 1980

Arab States Recycle Oil Surpluses to LDCs

[redacted]

[redacted]

The flow of Arab petrodollars to the LDCs is gaining momentum, although still only a fraction of the more than [redacted] anticipated for LDCs in 1980. In addition to official development assistance, [redacted] The most important sponsors [redacted] have favored Islamic states in the Middle East and Africa in their dealings. Even

5

22 May 1980

[redacted]

9 DECEMBER 1981

[redacted]

these dealings, however, have generally been on strictly commercial terms. For example, the [redacted], with assets well in excess [redacted], are lending to LDC governments and their state companies at prevailing market rates. [redacted]

[redacted]

Non-OPEC LDCs: Majority in Economic Trouble * (U)

The last 18 months have seen a widening gap in economic performances between those non-OPEC LDCs that export oil and those that do not. This has been especially pointed in the spreads between their respective current account growth indicators and their high and rising inflation rates. (U)

A key turning point came in late 1978, and marked deterioration continued throughout 1979. For the nearly 100 LDCs in the non-oil-exporting group,** the results were readily apparent in the standard indicators:

- The real rate of growth of GNP fell 0.5-1.0 percentage points. For the group as a whole, this meant a decline from 5.0 in 1978 to 4.5 percent in 1979; excluding the volatile Indian and Argentine economies, the comparable figures were 6.4 and 5.4 percent, respectively.***
- The combined inflation rate rose 11 points. Overall, this meant an increase from 35 percent (1978) to 46 percent (1979). However, removing hyperinflated Argentina and Brazil, the comparable rates were 12 percent and 18 percent.
- The deficit in the current account rose to $38 billion, as the net increase in the oil bill alone ran about $10 billion. (U)

The principal element in this slide from the fairly buoyant 1976-78 period was the new oil crisis. Beginning with the Iranian production cutback in late 1978, many LDCs were sent scurrying onto the spot oil market to meet their oil needs, and their import bills rose sharply. Unsettled economic conditions in the developed countries and revised OPEC development plans also prevented many LDCs from expanding exports as rapidly as in the past. The return of poor crop conditions in the Sahel, the Indian subcontinent, and parts of Latin America also sapped growth rates there. Faced with these factors, several LDCs—Brazil and South Korea stand out—had already projected sharp changes in their economic policies before the official OPEC oil prices took off in early 1979. (U)

By and large, the economies of the non-OPEC LDCs are in for rough sailing again this year. Further hikes in oil prices since 1979, generally poor economic performance in the OECD countries, and slowed OPEC development programs will again affect most of the group. We project that:

- Their current account deficit will soar some 15 billion to reach $53 billion.
- Excluding India and Argentina, their real growth will fall nearly another percentage point from 1979.
- Recent high inflation rates will remain essentially the same despite the falloff in growth. (U)

The course of events in 1981 is critical. If the non-oil-exporting LDCs experience another sharp deterioration in their terms of trade they could be back to the conditions of 1975, their worst overall economic performance in the past quarter century, and would have to constrain imports even more severely. Irrespective of events next year, the clear signals are that LDC economic growth rates will for some time remain well below the high rates (6 to 8 percent) of the 1960s and 1970s. The likelihood of rising oil prices, and the absence of any major energy alternatives to oil in most LDCs augur generally slower gains in per capita incomes through much of the Third World during the 1980s. For an increasing number of countries—particularly in

* This article is based on a soon-to-be published intelligence assessment entitled *Economic Outlook for the Non-OPEC LDCs* (Confidential). (U)

** This subgroup includes all the non-OPEC LDCs except Bahrain, Egypt, Malaysia, Mexico, Oman, Peru, Syria, and Trinidad and Tobago. It accounts for 88 percent of gross non-OPEC LDC oil exports. (U)

*** All group growth and inflation rates in this article are GNP-weighted. The base year for the weights is 1976. (U)

[redacted]

Sub-Saharan Africa and the Caribbean basin—this setback will amplify serious and persistent problems with rapid urbanization and declining food self-sufficiency. (U)

The Outlook for 1980

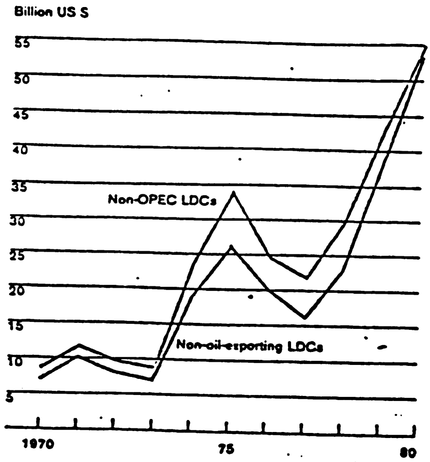
Even the most slow-reacting LDC policymakers now grasp that 1980 will be an especially difficult year. The single factor in the overall current account deterioration among non-oil-exporting LDCs will be the increase in their oil import bills. Particular growth and inflation rates will largely depend on the capacities of individual LDCs to accommodate this continued disturbance. For many LDCs, the broad strategy will be to (a) hold the volume of oil imports constant, (b) take whatever import growth is possible in capital goods and raw materials, (c) run down exchange reserves and real inventories, and (d) accept slower economic growth. Indeed, features of this strategy are already evident in early economic returns and policy announcements throughout the Third World. (U)

The Current Account. Higher oil bills, the continued soft demand in OECD markets, and steady rises in the prices of imports augur a [redacted] in the current account of the non-oil-exporting LDCs. The largest component of this figure [redacted] Many of the middle-income, non-oil-exporting LDCs [redacted] through 1980 without radically changing their patterns of borrowing or debt repayment; they [redacted]

The press of these problems will be especially strong in countries [redacted] where there is some development of domestic industry but virtually all fuels are imported. [redacted]

For some smaller or more backward oil-importing countries, payments problems will tend to be handled as they come to a head. Many [redacted] will be forced by international lenders to put the clamps on as a prerequisite to needed debt rescheduling. For [redacted] forced austerity will continue as the government seeks to reschedule its entire stock of debt. [redacted]

Non-OPEC LDCs: Current Account Deficits



Unclassified

Financing the 1980 Deficit. A combined current account deficit of [redacted] If they try to maintain their yearend 1979 position of holding sufficient foreign exchange to finance four months of imports, they would have to muster close to [redacted] on the capital account beyond likely foreign private investment and programed foreign aid. Some of this will come from the IMF and other international institutions, but a large share will have to be covered by private lenders. Most likely, the outcome will be some reduction in foreign exchange reserve/import ratios, the amount

[redacted]

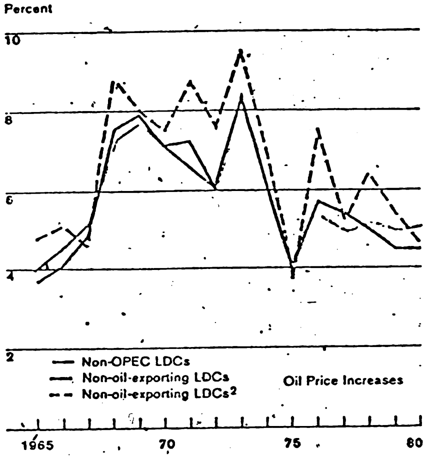
dependent on average spreads and interest rates for funds in private capital markets. The implication is that the already growing debt-service ratios of the LDCs—especially those in the middle-income rank—will spurt up again over the next several years. (C)

Although we do not foresee a widespread problem in securing private financing this year, [redacted] Even among some of the smaller middle-income countries, [redacted] For example, [redacted]

The private financial markets will not, of course, take up all of the funding problems of the LDCs. LDCs that are simply considered bad risks because of past problems in meeting debt payments or that have done little prior borrowing on the private markets may encounter even more serious financing problems this year. Countries that have had no experience on private markets because of a narrow export base or other reasons will continue to be dependent upon [redacted]

Output Growth. Overall, the non-oil-exporting LDCs—less India and Argentina *—will probably see a drop of nearly 1 percentage point in weighted GNP growth to about 4.5 percent in 1980. Advanced LDCs like Brazil, South Korea, and Taiwan will have the most difficulty sustaining previous growth rates. To varying degrees, their growth will be held back by large current account deficits that restrain imports, inflation-fighting policies, and the

Non-OPEC LDCs:
Real GNP Growth Rates[1]



[1] Weighted by 1976 GNP.
[2] Excluding Argentina and Brazil.

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falloff in export demand. Some of the non-oil-exporting LDCs will turn in a better-than-average growth performance despite adverse conditions in the world economy because of favorable export earnings (Chile) or expected agricultural improvements (Bangladesh and a few of the Sub-Saharan African LDCs). (U)

Almost half of the non-oil-LDCs will experience growth less than the weighted group average. The poor performers run the gamut from the very poor [redacted] to some upper-middle-income countries [redacted], and from the totally oil-deficient (Madagascar) to some small oil exporters (Angola, Bolivia, Zaire). As in 1979, [redacted] usually among the faster growing

* India and Argentina are removed because their large GNP weights and unusual circumstances—India's recovery from severe drought and Argentina's volatile swings in output during the last several years—would distort the analysis. (U)

[redacted]

[redacted]

Non-Oil-Exporting LDCs: Comparative Growth Performances in 1980

Better Performance Than the Non-Oil-Exporting Group Average			
Bangladesh	Jordan	Paraguay	Thailand
Benin	Lesotho	Senegal	Tunisia
Burma	Malawi	Seychelles	Upper Volta
Cameroon	Mali	Singapore	
Chile	Mauritius	Sri Lanka	
Hong Kong	Nicaragua	Taiwan	
Near the Non-Oil-Exporting Group Average [a]			
Argentina	Cyprus	Liberia	Rwanda
Barbados	Dominican Republic	Mauritania	Swaziland
Botswana	Gambia	Niger	Togo
Brazil	Honduras	Pakistan	Uruguay
Chad	India	Philippines	Yemen, AR
Colombia	Ivory Coast	Rhodesia	
Worse Than the Non-Oil-Exporting Group Average			
Afghanistan	Fiji	Madagascar	Sierra Leone
Angola	Ghana	Morocco	Sudan
Bahamas	Grenada	Mozambique	Suriname
Bolivia	Guatemala	Namibia	Tanzania
Burundi	Guinea	Nauru	Tonga
Central African Republic	Guinea-Bissau	Nepal	Uganda
Comoros	Guyana	Panama	Western Samoa
Congo, PR	Haiti	Papua New Guinea	Yemen, PDR
Costa Rica	Jamaica	Sao Tome and Principe	Zaire
El Salvador	Kenya	South Korea	Zambia
Ethiopia			

[a] Countries in this group are expected to come within half a percentage point of the group's weighted average GNP growth of 4.5 percent.

Unclassified

economics, stood out near the bottom of the list because of their heavy oil-import dependence. [redacted]

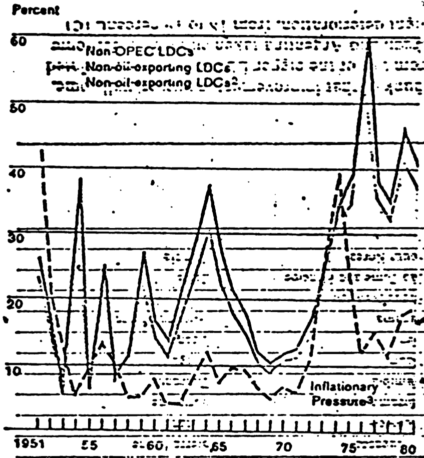
Inflation. The inflation outlook is [redacted] after last year's sharp runup. The non-oil-LDCs as a whole will probably show some subsidence, [redacted] this year. A large chunk of that improvement, however, will come from [redacted]

Price increases for both petroleum and nonoil imports will continue to hurt most of the non-oil-exporting LDCs as they work their way through the domestic economies. These factors will again make

[redacted]

[redacted]

Non-OPEC LDCs: Aggregate Inflation Rates[1]



[1] Weighted by 1976 GNP.
[2] Excluding Argentina and Brazil.
[3] Overly expansive fiscal and monetary policies, commodity export boom, and the 1973/74 oil crisis.

Unclassified

matters worse for those LDCs [redacted] that have been experiencing serious stabilization problems for the last few years. Lifting of price controls on basic consumer items or the removal of subsidies will, in the short run, be reflected in non-oil-exporting LDCs [redacted] Expected high levels of deficit spending will add to the inflation woes of [redacted]

Rising revenues from commodity exports and growing deficit spending will [redacted]

[redacted]

Scenarios for 1981

LDCs are running out of policy options that can simultaneously accommodate soaring oil prices and programs for economic growth and development. If official oil prices next year are held to an average of [redacted] per barrel the resulting small improvement in the LDC terms of trade would allow policymakers to put aside for a time the overriding problem of paying the oil bill and instead focus on financial and resource allocation policies that could stimulate economic growth [redacted] At the moment, most forecasts of OECD growth for 1980 and 1981 are becoming increasingly pessimistic. [redacted]

Assuming [redacted], countries such as [redacted] would [redacted] Improved export performance could be enough to push the non-oil-exporting LDC aggregate growth rate [redacted] for the first time since 1977 and shave [redacted] most of them. Even in this case, exporters of a narrow range of price-stable primary products, [redacted] would see little, if any, improvement in growth rates [redacted]

[redacted] next year the non-oil-exporting LDCs would [redacted]. Growth rates would again turn in [redacted], and [redacted] Advanced LDC manufactures exporters and primary goods producers alike would [redacted]

[redacted] 29 May 1980

[redacted]

[redacted]

Non-Oil-Exporting LDCs: Comparative Inflation Performances in 1980

Better Performance Than the Non-Oil-Exporting Group Average (less than 13 percent)

Bahamas	Gambia	Madagascar	Taiwan
Burma	Hong Kong	Malawi	Tunisia
Chad	India	Mauritania	Yemen, PDR
Costa Rica	Kenya	Mauritius	
Cyprus	Liberia	Singapore	

Near the Non-Oil-Exporting Group Average (13 to 23 percent)[1]

Afghanistan	Grenada	Nepal	Somalia
Bangladesh	Guatemala	Nicaragua	South Korea
Barbados	Guyana	Niger	Sri Lanka
Bolivia	Haiti	Pakistan	Suriname
Cameroon	Honduras	Panama	Swaziland
Cape Verde	Ivory Coast	Philippines	Thailand
Central African Republic	Jamaica	Rhodesia	Togo
Chile	Jordan	Rwanda	Zambia
Congo, PR	Lesotho	Senegal	
Ethiopia	Morocco	Sierra Leone	

Worse than the Non-Oil-Exporting Group Average (more than 23 percent)

Argentina	El Salvador	Tanzania	Yemen, AR
Brazil	Ghana	Uganda	Zaire
Colombia	Paraguay	Upper Volta	
Dominican Republic	Sudan	Uruguay	

[1] The countries in this group are expected to come within 5 percentage points of the group's weighted average inflation of 18.6 percent (excluding Brazil and Argentina). Brazil and Argentina are excluded because of their hyperinflation and big weights.

Unclassified

[redacted] The non-oil-exporting LDCs in the best position to survive such a scenario are those largely energy-self-sufficient [redacted] and those that would make little economic progress in any case [redacted]

important deletion

[redacted]
29 Mar 1980

[redacted]

Petrodollar Recycling at Midyear (U)

[redacted]

14 C 1.4

[redacted] we believe that for at least 1980 the balance-of-payments financing requirements are being met with a minimum of disruption. The system has managed well thus far because the increase in the non-OPEC current account deficit is concentrated in countries well able to finance their payments gaps, international capital markets are highly liquid, interest rates have declined, and ample funds are available through international financial institutions. [redacted]

[redacted] Annual OPEC current account surpluses [redacted] Moreover, the countries in the best position to finance large deficits will be reducing their imbalance as their domestic growth slows—[redacted] This means the smaller OECD countries will probably see [redacted] To the extent that these approaches fail, these countries will [redacted]

Magnitude of 1980 Recycling Needs

Based on an average oil price of [redacted] we currently estimate a [redacted]

We expect this upsurge [redacted] to the combined deficit of the OECD countries and [redacted] to that of the non-OPEC LDCs. Last year the deficits of the developed and the developing countries rose by similar amounts. Nearly [redacted] of the total rise in the current account deficit of the non-OPEC countries is expected to be absorbed by [redacted] the smaller OECD countries and the non-OPEC LDCs will each [redacted]

OECD Countries

The major developed countries appear to be having little difficulty handling the [redacted] in their payments accounts. Their external financing policies suggest a positive encouragement of capital inflows or a relaxation of previous restraints on such inflows. [redacted] 1980 current account deficit, now estimated at [redacted] is being covered by short-term capital inflows and restraints on long-term outflows; [redacted] Capital inflows, under direct encouragement or relaxed restraints, are figuring prominently in financing the estimated [redacted] should be easily managed following three consecutive years of large surpluses which helped accumulate official reserves [redacted]

* All current account balances in this article exclude official transfers. (U)

[redacted]

[redacted]

9 DECEMBER

[redacted]

Non-Communist Countries: Current Account Shifts [1]

Billion US $

	Current Account Balance 1979	Current Account Balance 1980	Change in 1980	Due to Change in: Oil Balance	Due to Change in: Balance of Other factors
Total OECD and Non-OPEC LDCs [2]	−60.6	[redacted]	[redacted]	[redacted]	[redacted]
OECD	−17.6	[redacted]	[redacted]	[redacted]	[redacted]
United States	4.9	[redacted]	[redacted]	[redacted]	[redacted]
Big Six	5.1	[redacted]	[redacted]	[redacted]	[redacted]
Japan	−8.0	[redacted]	[redacted]	[redacted]	[redacted]
West Germany	0.9	[redacted]	[redacted]	[redacted]	[redacted]
France	3.3	[redacted]	[redacted]	[redacted]	[redacted]
United Kingdom	−0.7	[redacted]	[redacted]	[redacted]	[redacted]
Italy	3.6	[redacted]	[redacted]	[redacted]	[redacted]
Canada	−4.2	[redacted]	[redacted]	[redacted]	[redacted]
Smaller OECD	−17.4	[redacted]	[redacted]	[redacted]	[redacted]
Of which:					
Denmark	−3.5	[redacted]	[redacted]	[redacted]	[redacted]
Greece	−2.3	[redacted]	[redacted]	[redacted]	[redacted]
Portugal	0.2	[redacted]	[redacted]	[redacted]	[redacted]
Spain	1.0	[redacted]	[redacted]	[redacted]	[redacted]
Sweden	−3.6	[redacted]	[redacted]	[redacted]	[redacted]
Turkey	−1.1	[redacted]	[redacted]	[redacted]	[redacted]
Non-OPEC LDCs	−43.0	[redacted]	[redacted]	[redacted]	[redacted]
Of which:					
Nonoil-exporting LDCs	−36.0	[redacted]	[redacted]	[redacted]	[redacted]
Of which:					
Argentina	0.2	[redacted]	[redacted]	[redacted]	[redacted]
Brazil	−9.6	[redacted]	[redacted]	[redacted]	[redacted]
Chile	−0.9	[redacted]	[redacted]	[redacted]	[redacted]
Hong Kong	−1.8	[redacted]	[redacted]	[redacted]	[redacted]
India	−0.5	[redacted]	[redacted]	[redacted]	[redacted]
Ivory Coast	−1.0	[redacted]	[redacted]	[redacted]	[redacted]
Pakistan	−1.5	[redacted]	[redacted]	[redacted]	[redacted]
Philippines	−1.7	[redacted]	[redacted]	[redacted]	[redacted]
South Korea	−4.2	[redacted]	[redacted]	[redacted]	[redacted]
Taiwan	0.8	[redacted]	[redacted]	[redacted]	[redacted]
Thailand	−1.8	[redacted]	[redacted]	[redacted]	[redacted]
OPEC	66.8	[redacted]	[redacted]	[redacted]	[redacted]

[1] Projected; all balances exclude official transfers.
[2] Excluding South Africa, Israel, Malta, and protectorates and trusts.
[redacted] oil balance change is change in imports of fuels and lubricants.

[redacted]

[redacted]

Most smaller OECD countries are increasing their borrowing on international capital markets, and few problems are expected [redacted]

Sweden plans to hold public external borrowing at approximately last year's level and is encouraging private borrowing to finance a [redacted] aleady has covered a sizable portion of its estimated [redacted] for the year with Eurocurrency loans. [redacted]

[redacted] appears to be able to cover its prospective 1980 current account deficit of [redacted] So far [redacted] has arranged over [redacted] in new loans and grants from major OECD countries, the IMF, and the World Bank. [redacted]

Non-OPEC LDCs

The non-OPEC LDCs are having mixed success in financing their combined deficit of [redacted]

[redacted]

Non-OPEC LDCs: External Financing — Billion US $

	1978	1979	1980 [1]
Uses of external financing	[redacted]	[redacted]	[redacted]
Current account deficit (goods, services, and private transfers)	[redacted]	[redacted]	[redacted]
Less: official net transfers to LDCs	[redacted]	[redacted]	[redacted]
Current account deficit (goods, services, private and official transfers)	[redacted]	[redacted]	[redacted]
Amortization of medium- and long-term external debt	[redacted]	[redacted]	[redacted]
Change in international reserves	[redacted]	[redacted]	[redacted]
Sources of external financing	[redacted]	[redacted]	[redacted]
Direct investment, net	[redacted]	[redacted]	[redacted]
Medium- and long-term borrowing (gross)	[redacted]	[redacted]	[redacted]
Of which:			
Medium- and long-term borrowing (net)	[redacted]	[redacted]	[redacted]
Other capital, net [2]	[redacted]	[redacted]	[redacted]
Memorandum items			
Gross borrowing in private capital markets	[redacted]	[redacted]	[redacted]
World Bank credits, net [1]	[redacted]	[redacted]	[redacted]

[1] Estimated.
[2] Includes residual errors.

[redacted]

Multilateral institutions are playing an expanded role in covering the 1980 deficits. IMF lending is up sharply this year; drawings through April 1980 totaled $1.2 billion, compared with $2.4 billion for all of 1979. Over $9 billion remains available from the Fund's Supplementary Financing (Witteveen) Facility for balance-of-payments support. Moreover, IMF members are expected to ratify a 50-percent increase in subscription quotas later this year. If so, the General Resources Account will rise to $76 billion. (U)

[redacted]

[redacted]

[redacted] The Bank plans to distribute some $800 million annually under a recent policy change permitting more program lending for quick balance-of-payments support compared with slower flowing project loans. Turkey and Kenya have already borrowed $200 million and $55 million, respectively, under the new policy. [redacted]

The Longer Term Outlook

Optimism about the recycling outlook dissipates rapidly looking beyond the short term. [redacted]

[redacted]

International institutions already are moving to address the longer term financing problems. The IMF has been authorized to negotiate with individual countries for supplementary financing should the need arise and will be making a $5 billion Special Drawing Rights allocation in January 1981. The World Bank's authorized capital has been doubled to $80 billion, although no new money has yet been placed with the Bank. The authorized capital of other multilateral development banks also is being increased in anticipation of expanded demand on their resources. [redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

OPEC: The 1980 Current Account Surplus and Its Placement (U)

An [redacted] Assessment

Research for this report was completed on 20 February 1980.

[redacted]

[redacted]

February 1980

[redacted]

9 DECEMBER 19

[redacted]

OPEC: The 1980 Current Account Surplus and Its Placement (U)

Overview

Soaring revenues together with relatively slow growth in imports now seem likely to drive this year's OPEC current account surplus to [redacted] following an estimated $69 billion surplus in 1979. [redacted]

While this [redacted] as large as the $66 billion reached in 1974, the 1980 surplus has [redacted] Simply deflating the surplus by US inflation since 1974 reduces it to [redacted] 1974 prices. If real growth in economic variables is also taken into account, [redacted] The 1974 OPEC surplus was about 1.8 percent of the nominal gross national product ($3.6 trillion), of the Organization for Economic Cooperation and Development (OECD); the comparable 1980 figure is [redacted] As a share of the nominal exports of goods and services of the Free World oil consuming countries, the 1980 OPEC surplus will be less than [redacted] compared with 8.7 percent in 1974. [redacted]

As in 1974, the surplus will be concentrated in the larger Persian Gulf states, with [redacted] expected to have a 1980 current account balance of about [redacted] should account for another [redacted] Only [redacted] and [redacted] are likely to boost import spending fast enough to stay in the red, despite sizable hikes in their oil revenues. [redacted]

[redacted]

In the period 1974-78, the OPEC surplus surged in the first year following the big oil price increases and then dwindled to insignificance in the ensuing four years. [redacted] For instance, if OECD growth

[redacted]

[redacted]

recovers to [redacted] the OPEC surplus would registe[redacted] Lower growth would reduce this figure, whereas [redacted]

The size of the surplus is very sensitive to changes in oil export volume, oil prices, and import volume. For instance, each dollar change in the average oil price or a change in oil export volume of 1 million barrels per day would change the surplus by $10 billion. An increase in OPEC's import volume growth by 1 percentage point would reduce this year's surplus by more than $1 billion. (U)

[redacted]

[redacted]

[redacted]

OPEC: The 1980 Current Account Surplus and Its Placement (U)

Oil Export Earnings

Official OPEC prices now average $29 per barrel; spot market premiums, $10 or higher in mid 1979, have largely disappeared. Discrepancies persist, however, among official prices for competitive types of crude produced in different countries, making future price adjustments likely. These adjustments are more likely to be upward than downward, leading to an average OPEC price of about [redacted] for the year. [redacted]

Higher prices and increased non-OPEC energy supplies, combined with much slower growth [redacted] non-OPEC demand for OPEC oil by about [redacted] per day (b/d) below last year's 29 million barrels. [redacted] (see table 2 and 3). [redacted]

While the average of OPEC countries' official prices is expected to [redacted] the average price for individual countries varies considerably, mainly reflecting quality and transportation differentials. In addition, not all transactions take place at the official price. After allowing for transfers of oil under equity and buy-back arrangements, we expect the average realized price [redacted]

[1] See "The World Oil Market in 1980" in the 6 February issue of the *International Energy Weekly Review* for a more detailed discussion of supply and demand outlook; see ER M 79-10704, *A Methodological Approach for Calculating the Economic Implications of High Market Clearing Prices*, December 31, 1979, for an explanation of some of the underlying analytical methods. (U)

Table 1 Billion US $

OPEC: Current Account Balance [1]

	1974	1975	1976	1977	1978	1979 [2]	[redacted]
Trade Balance	80.4	49.4	61.1	57.7	40.1	104.0	[redacted]
Exports (f.o.b.)	118.2	107.9	131.4	146.4	140.3	208.1	[redacted]
Oil	111.6	101.6	123.5	137.1	129.7	196.2	[redacted]
Nonoil	6.5	6.4	7.9	9.3	10.7	11.8	[redacted]
Imports (f.o.b.)	37.7	58.5	70.3	88.7	100.3	104.1	[redacted]
Net Services & Private Transfers	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Freight & Insurance	−4.5	−8.1	−10.8	−12.1	−13.6	−14.0	[redacted]
Investment Income Receipts	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Other	−8.7	−12.5	−18.3	−24.0	−29.9	−32.5	[redacted]
Grants	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Current Account Balance	66.2	30.1	35.1	25.6	4.4	69.1	[redacted]

[1] Because of rounding components may not add to the totals shown.
[2] Estimated.
[3] Projected.

This table is [redacted]

1

[redacted]

[redacted]

Table 2 — Thousand b/d

OPEC: Oil Production[1]

	1974	1975	1976	1977	1978	1979	[redacted]
OPEC	31,060	27,545	31,165	31,890	30,340	31,430	
Algeria	1,010	1,025	1,085	1,170	1,265	1,180	
Ecuador	175	160	185	185	205	220	
Gabon	200	225	225	220	210	200	
Indonesia	1,375	1,305	1,515	1,695	1,665	1,640	
Iran	6,065	5,395	5,930	5,705	5,245	3,040	
Iraq	1,970	2,260	2,415	2,500	2,520	3,410	
Kuwait	2,595	2,135	2,195	2,025	2,170	2,635	
Libya	1,540	1,505	1,975	2,105	2,015	2,090	
Nigeria	2,255	1,785	2,070	2,085	1,910	2,300	
Qatar	525	450	505	450	485	520	
Saudi Arabia	8,610	7,215	8,760	9,415	8,545	9,855	
United Arab Emirates	1,680	1,665	1,935	2,015	1,860	1,860	
Venezuela	3,060	2,420	2,370	2,320	2,245	2,480	

[1] Including natural gas liquid.
[2] Projected.

[redacted]

Table 3 — Thousand b/d

OPEC: Oil Export Volume

	1974	1975	1976	1977	1978	1979	[redacted]
OPEC	29,407	25,826	29,308	29,767	28,021	28,955	
Algeria	939	946	1,002	1,076	1,161	1,067	
Ecuador	139	122	141	135	149	160	
Gabon	179	213	205	195	193	180	
Indonesia	1,168	1,079	1,268	1,396	1,332	1,277	
Iran	5,618	4,914	5,476	5,191	4,705	2,473	
Iraq	1,880	2,169	2,323	2,373	2,344	3,225	
Kuwait	2,458	2,014	2,035	1,916	2,041	2,504	
Libya	1,504	1,455	1,919	2,038	1,941	2,009	
Nigeria	2,201	1,716	1,960	1,970	1,756	2,132	
Qatar	521	445	499	442	476	510	
Saudi Arabia	8,285	6,940	8,401	9,023	8,145	9,423	
United Arab Emirates	1,673	1,639	1,903	1,967	1,807	1,800	
Venezuela	2,812	2,174	2,126	2,045	1,968	2,195	

[1] Projected.

[redacted]

[redacted]

[redacted]

Multiplying our projected price and quantity figures by the 366 days in 1980 (a leap year) yields our projection of [redacted] percent over [redacted] oil revenues, and [redacted] than the [redacted] figure (see tables 4 and 5). [redacted]

Nonoil Exports
Nonoil OPEC exports are expected to rise from $11.8 billion in 1979 to $14.6 billion in 1980, falling as a share of total export revenues from 5.7 percent last year to about 5 percent this year. Indonesia, which accounts for nearly half of the total, should see a sizable expansion in its nonoil exports. Demand for the traditional commodities, (wood, rubber, tin, and coffee) is expected to remain strong, leading to higher prices and export earnings even if Indonesia's export capacity grows only slowly. Capacity limitations will keep Indonesia's liquefied natural gas (LNG) export volume constant, but increases in price should generate an additional $800 million more than the $1.4 billion achieved in 1979 (see table 6). (U)

LNG will play the key role in raising Algeria's nonoil exports to the $1 billion mark this year, a two-thirds jump from the $0.6 billion registered in 1979. Most of the rise in shipments will go to the United States and Western Europe. Further rapid growth is likely in the next few years as the government pushes development of gas pipelines, liquefaction plants, and LNG carriers. Reportedly, SONATRACH—the state hydrocarbon agency—has concluded contracts which by 1985 could involve LNG exports of 1.9 trillion cubic feet, more than two and a half times current commitments. (U)

Kuwait's nonoil exports are also rising, based on expansion of fertilizer production. In the mid-1970s, reexports of goods destined for Iraq and Iran accounted for as much as 75 percent of Kuwait's total nonoil exports, owing to the suspension of operations at the port of Beirut and extreme congestion in neighboring Gulf ports. Although reexports have dropped and probably will continue to decline, the expected increase in both the volume and price of fertilizer—particularly urea—should more than make up the difference. [redacted]

Table 4 — US $ Per Barrel

OPEC: Average Price of Oil

	1974	1975	1976	1977	1978	1979	[redacted]
OPEC	10.40	10.77	11.51	12.62	12.68	18.57	
Algeria	13.64	12.14	13.01	14.36	14.14	20.66	
Ecuador	10.89	10.64	10.68	12.46	11.93	20.34	
Gabon	7.94	9.78	10.44	11.48	11.27	14.27	
Indonesia	9.96	10.75	10.97	12.25	12.25	17.10	
Iran	10.13	10.71	11.37	12.57	12.51	22.40	
Iraq	10.15	10.81	11.61	12.74	12.72	18.69	
Kuwait	9.48	10.35	11.15	12.12	12.23	18.37	
Libya	12.56	11.59	12.28	13.87	13.69	20.68	
Nigeria	11.13	11.39	12.63	14.08	13.61	20.24	
Qatar	10.20	11.00	11.67	12.89	12.91	19.80	
Saudi Arabia	10.03	10.50	11.26	12.04	12.33	16.90	
United Arab Emirates	11.45	10.84	11.55	12.43	12.77	19.15	
Venezuela	9.93	10.53	11.14	12.59	12.61	17.17	

* Projected.

[redacted]

[redacted]

[redacted]

[redacted]

Table 5 — Billion US $

OPEC: Oil Export Earnings

	1974	1975	1976	1977	1978	1979 [1]	[redacted]
OPEC	111.6	101.6	123.5	137.1	129.7	196.2	
Algeria	4.7	4.2	4.8	5.6	6.0	8.0	
Ecuador	0.6	0.5	0.6	0.6	0.6	1.2	
Gabon	0.5	0.8	0.8	0.8	0.8	1.0	
Indonesia	4.2	4.2	5.1	6.2	6.0	8.0	
Iran	20.8	19.2	22.8	23.8	21.5	20.2	
Iraq	7.0	8.6	9.9	11.0	10.9	22.0	
Kuwait	8.6	7.6	8.5	8.5	9.1	16.8	
Libya	6.9	6.2	8.6	10.3	9.7	15.2	
Nigeria	8.9	7.1	9.1	10.1	8.7	15.8	
Qatar	1.9	1.8	2.1	2.1	2.2	3.7	
Saudi Arabia	30.3	26.6	34.6	39.7	36.7	58.1	
United Arab Emirates	7.0	6.5	8.0	8.9	8.4	12.6	
Venezuela	10.2	8.4	8.7	9.4	9.1	13.8	

[1] Estimated.
[2] Projected.

[redacted]

Table 6 — Billion US $

OPEC: Nonoil Export Earnings [1]

	1974	1975	1976	1977	1978	1979 [2]	[redacted]
OPEC	6.5	6.4	7.9	9.3	10.7	11.8	
Algeria	0.6	0.6	0.5	0.3	0.5	0.6	
Ecuador	0.4	0.4	0.6	0.7	1.0	0.6	
Gabon	0.2	0.3	0.3	0.3	0.3	0.4	
Indonesia	2.2	1.8	2.5	3.6	4.2	5.4	
Iran	0.8	0.8	0.9	0.7	0.7	0.4	
Iraq	0.1	0.1	0.2	0.3	0.3	0.3	
Kuwait	0.4	0.6	0.7	0.8	0.8	1.0	
Libya	NEGL	NEGL	NEGL	NEGL	NEGL	NEGL	
Nigeria	0.7	0.6	0.7	0.8	1.0	1.1	
Qatar	NEGL	0.1	0.3	0.3	0.3	0.3	
Saudi Arabia	NEGL	0.1	0.1	0.1	0.1	0.1	
United Arab Emirates	0.4	0.5	0.6	0.9	1.0	1.1	
Venezuela	0.5	0.5	0.5	0.4	0.5	0.5	

[1] Because of rounding, components may not add to the totals shown.
[2] Estimated.
[3] Projected.

[redacted]

[redacted]

Imports

In 1974 the value of OPEC's merchandise imports jumped by 84 percent; in 1980 it is expected to increase by about [redacted] percent. The import base has grown much larger in the interim, making a slowdown in percentage rates of growth almost inevitable: OPEC's 1973 import base was about $20 billion, whereas the estimated 1979 figure is $104 billion. In addition, the views of several important OPEC countries toward the desired pace of economic development have changed markedly (see table 7). Altogether, we project OPEC import volume gains this year of about [redacted] percent, with average import prices rising by [redacted] percent. [redacted]

The most striking shift has taken place in Iran. With the repudiation of many of the former regime's grandiose spending schemes and the continuing turmoil engendered by the Revolutionary Government, Iran's imports dropped from [redacted] billion in 1978 to an estimated [redacted] billion in 1979. Even so, if Iranian imports recover to the [redacted] billion level projected for 1980, it will represent [redacted]

Events in Iran, moreover, have been interpreted prophetically in other Middle Eastern OPEC countries which, in the wake of economic modernization programs, have seen their traditional social values threatened and have experienced distribution bottlenecks, accelerated inflation, increased exposure to foreign influence, widened income disparities, and increasing corruption. Their response is to hold a tight rein on spending, despite enormous revenue increases. (U)

Planners in Saudi Arabia—by far OPEC's largest importer with purchases estimated [redacted]4 billion in 1979—are projecting government outlays for the Third Five-Year Plan (FY 1981-85) that represent no increase in real terms compared with actual expenditures under the preceding five-year plan. Growth rates for the nonoil sectors reportedly will be pared by one-third. In Kuwait, planned spending of $8 billion for the FY 1980 budget implies little real growth. Less than 2 percent of the nominal increase is slated for development. No plans for major new industrial projects are on the books, instead priority is given to

Table 7 — Percent

OPEC: Import Volume Growth

	1974	1975	1976	1977	1978	1979[1]		
OPEC	47	40	20	16	−1	−9	−5	[redacted]
Algeria	45	23	−6	25	−4	−1	−7	[redacted]
Ecuador	72	16	−1	42	−6	−10	7	[redacted]
Gabon	30	30	20	−4	−22	−5	−13	[redacted]
Indonesia	46	11	24	1	−5	1	2	[redacted]
Iran	44	63	6	3	−9	−57	−57	[redacted]
Iraq	154	49	−7	−6	−4	6	37	[redacted]
Kuwait	4	28	59	16	−7	4	−3	[redacted]
Libya	59	18	11	3	4	3	15	[redacted]
Nigeria	11	87	23	31	1	−16	−15	[redacted]
Qatar	16	62	69	19	−10	3	17	[redacted]
Saudi Arabia	77	49	68	30	12	7	5	[redacted]
United Arab Emirates	61	42	36	23	−3	4	7	[redacted]
Venezuela	20	25	29	35	−4	−9	−9	[redacted]

[1] Estimated.
[2] Projected.

[redacted]

[redacted]

[redacted]

construction projects already under way and to improving utilities and transportation facilities. The UAE and Qatar have adopted similar courses. [redacted]

The notable exception in the Persian Gulf to the policy of slow import growth is Iraq, which is scheduled to receive [redacted]. Iraqi imports are expected to rise in 1980 by [redacted] percent in volume and about [redacted] percent in value, the highest rates projected for any OPEC country (see table 8). [redacted]

The second highest rate of import growth in OPEC is likely to occur in Nigeria, where the surge in oil earnings now permits an easing of last year's austerity measures. Nigerian imports had increased nearly sixfold between 1973 and 1978, leading to a 1978 current account deficit of $4.3 billion and a government clampdown including an import ban on some consumer items, a 100-percent advance deposit on nonessential goods, and institution of preshipment inspection of import documents. As a result, the value of imports actually declined from $10.8 billion in 1978 to $10.5 billion in 1979. Lagos is now likely to permit a substantial pickup in imports—expected to rise by 16 percent in real terms and 35 percent in value—but not by so much as to eliminate a safety cushion in the form of a substantial current account surplus.[2] (U)

Indonesia and Venezuela, which customarily exhibit rapid import growth when revenues are available, are both in transitional stages of government planning. Hence, their imports are expected to rise slowly in 1980. Libyan imports, fueled by military purchases, will grow more rapidly than the OPEC average, while the imports of Algeria, Ecuador, and Gabon will be constrained by balance-of-payments considerations. [redacted]

Net Services and Private Transfers

We expect services and private transfers—an important negative item in the OPEC current account—to rise [redacted] percent this year, considerably more slowly than in the years immediately following the 1973/74 price hikes. Two factors are primarily responsible for

[2] See "Nigeria: Balance of Payments Turnaround" (Confidential Noforn) in the 11 January issue of the *Economic Intelligence Weekly Review* for a more detailed discussion of import policies. (U)

Table 8 — Billion US $

OPEC: Imports

	1974	1975	1976	1977	1978	1979[1]	[redacted]
OPEC	37.7	58.5	70.3	88.7	100.3	104.1	[redacted]
Algeria	4.0	5.5	5.1	7.0	7.7	8.8	[redacted]
Ecuador	0.9	1.1	1.1	1.7	1.8	1.8	[redacted]
Gabon	0.4	0.5	0.6	0.7	0.6	0.6	[redacted]
Indonesia	4.6	5.5	6.8	7.5	8.3	9.3	[redacted]
Iran	7.2	13.1	13.9	15.5	16.2	8.0	[redacted]
Iraq	3.5	5.8	5.4	5.5	6.1	7.3	[redacted]
Kuwait	1.6	2.2	3.5	4.4	4.7	5.6	[redacted]
Libya	3.4	4.5	4.9	5.6	6.6	7.9	[redacted]
Nigeria	2.5	5.2	6.4	9.2	10.8	10.5	[redacted]
Qatar	0.3	0.5	0.9	1.1	1.2	1.4	[redacted]
Saudi Arabia	4.0	6.6	11.1	15.6	20.0	24.4	[redacted]
United Arab Emirates	1.6	2.5	3.4	4.6	5.2	6.2	[redacted]
Venezuela	3.9	5.5	7.2	10.3	11.0	12.2	[redacted]

[1] Estimated.
[2] Projected.

This table [redacted]

[redacted]

[redacted]

the lower rate: [redacted]

Rapid growth of investment income can be expected as a direct result of the expanding OPEC surplus. The cumulative surplus during the 1974-79 period amounts [redacted] (see table 9). [redacted]

Freight and insurance payments are expected to rise at approximately the same rate as imports. Service contracts, worker remittances, and interest on foreign debt—the other principal items—are heavily influenced by [redacted] including ceilings on foreign manpower, are expected to hold the rise in [redacted] payments for these purposes to about [redacted] percent (see table 10). Conditions in [redacted] will also depress the rate of increase in other service payments, while government policies [redacted] and [redacted] are expected to have a similar effect in those countries. Most other OPEC countries are expected to increase their other service payments considerably more rapidly, but the net effect is to hold the overall rise to [redacted]

Grants

During the period 1974-79, OPEC member states disbursed [redacted] billion in bilateral grants, with [redacted] billion doled out in 1979 (see table 11). [redacted]

Table 9 — Billion US $

[redacted]

[redacted]

[redacted]

Table 10 — Billion US $

OPEC: Other Services

	1974	1975	1976	1977	1978	1979[1]
OPEC	8.7	12.5	18.3	24.0	29.9	32.5
Algeria	0.1	0.2	1.0	1.5	1.7	1.9
Ecuador	0.1	0.1	0.1	0.2	0.2	0.2
Gabon	0.3	0.4	0.4	0.4	0.4	0.4
Indonesia	0.6	0.9	1.4	1.6	2.2	2.2
Iran	0.9	1.3	1.4	1.9	2.4	1.3
Iraq	0.4	0.3	1.2	1.5	1.7	2.1
Kuwait	0.3	0.2	0.2	0.3	0.3	0.4
Libya	1.0	1.0	1.0	1.3	1.5	1.7
Nigeria	1.8	2.3	2.3	2.3	1.8	2.0
Qatar	0.2	0.3	0.3	0.4	0.4	0.5
Saudi Arabia	1.0	3.5	6.6	8.3	12.0	14.0
United Arab Emirates	1.3	0.9	1.4	2.4	2.7	3.1
Venezuela	0.7	0.9	0.9	1.7	2.6	2.6

[1] Estimated.
[2] Projected.

[redacted]

Table 11 — Billion US $

OPEC: Grants

[redacted]

[redacted]

OPEC grant aid is likely to increase in 1980 because the donors will be flush with funds and the oil price increase will have intensified the need of recipients. The increasing cost of military hardware coveted by some less developed countries (LDCs) and pleas for development assistance [redacted]

[redacted]

Although the current account will be affected only marginally by increased grants, the capital account should show a somewhat greater increase in concessionary lending. In January 1980, OPEC finance ministers set up an OPEC fund to replace the Special Fund created in 1976. [redacted]

Placement of the Surplus

[redacted]

Table 12 Percent

OPEC: Distribution of Official Foreign Assets (End of First Quarter, 1979)[1]

[redacted]

The variety of assets and present high interest rates available in US financial markets will ensure petrodollar inflows. [redacted]

[redacted]

The Outlook for 1981 and Beyond

[redacted]

Given the continuing influence on energy demand in 1981 of the 1979/80 price increases, and the expected additions to non-OPEC supply, demand for OPEC oil would [redacted] would be accommodated by the [redacted] in domestic OPEC consumption. [redacted]

[redacted] continued growth in OPEC imports and service and transfer payments are expected to raise current outflows by about [redacted] leading to [redacted] the 1981 OPEC surplus to [redacted]

Other 1981 scenarios are also plausible. Economic recovery in the industrial countries might well be slower than expected. [redacted] OECD growth near 1.5 percent is a distinct possibility, since governments may well react to inflation and payments problems this year with more restrictive economic policy. Alternatively, further [redacted]

Slower OECD growth in 1981 of 1 percentage point, with OPEC [redacted] would reduce demand for OPEC oil by [redacted] This would cut OPEC oil revenues by about [redacted] resulting in an OPEC surplus of a little over [redacted] If, however, OECD growth were forced down from a 2.5-percent rate [redacted] the net effect would be [redacted] even though [redacted] We estimate that a [redacted] for instance, would [redacted] off an ordinary recovery rate of [redacted] percent in the industrial countries and [redacted] This would lead to [redacted] and, depending on how much additional [redacted]

[redacted]

Appendix

Algeria:
Current Account

Billion US $

	1974	1975	1976	1977	1978	1979[1]	[redacted]
Trade Balance	1.3	−0.7	0.2	−1.1	−1.2	−0.1	[redacted]
Exports (f.o.b.)	5.2	4.8	5.3	5.9	6.5	8.7	[redacted]
Oil	4.7	4.2	4.8	5.6	6.0	8.0	[redacted]
Nonoil	0.6	0.6	0.5	0.3	0.5	0.6	[redacted]
Imports (f.o.b.)	−4.0	−5.5	−5.1	−7.0	−7.7	−8.8	[redacted]
Net Service & Private Transfers	[redacted]						
Freight & Insurance	−0.4	−0.7	−0.6	−0.8	−0.9	−1.1	[redacted]
Investment Income Receipts	[redacted]						
Other	−0.1	−0.2	−1.0	−1.5	−1.7	−1.9	[redacted]
[redacted]	[redacted]						
Current Account Balance	0.8	−1.4	−1.3	−3.3	−3.6	−3.0	[redacted]

[1] Estimated.
[2] Projected.

[redacted]

 [redacted]

[redacted]

Ecuador:
Current Account

Billion US $

	1974	1975	1976	1977	1978	1979 [1]	[redacted]
Trade Balance	0.1	−0.2	0.0	−0.3	−0.2	0.0	[redacted]
Exports (f.o.b.)	1.0	0.9	1.1	1.4	1.6	1.8	[redacted]
Oil	0.6	0.5	0.6	0.6	0.6	1.2	[redacted]
Nonoil	0.4	0.4	0.6	0.7	1.0	0.6	[redacted]
Imports (f.o.b.)	−0.9	−1.1	−1.1	−1.7	−1.8	−1.8	[redacted]
Net Service & Private Transfers	[redacted]						
Freight & Insurance	−0.1	−0.1	−0.1	−0.2	−0.2	−0.2	[redacted]
Investment Income Receipts	[redacted]						
Other	−0.1	−0.1	−0.1	−0.2	−0.2	−0.2	[redacted]
[redacted]	[redacted]						
Current Account Balance	−0.1	−0.5	−0.3	−0.7	−0.5	−0.4	[redacted]

[1] Estimated.
[2] Projected.

[redacted]

Gabon:
Current Account

Billion US $

	1974	1975	1976	1977	1978	1979 [1]	[redacted]
Trade Balance	0.4	0.5	0.5	0.5	0.5	0.7	[redacted]
Exports (f.o.b.)	0.8	1.0	1.1	1.2	1.1	1.4	[redacted]
Oil	0.5	0.8	0.8	0.8	0.8	1.0	[redacted]
Nonoil	0.2	0.3	0.3	0.3	0.3	0.4	[redacted]
Imports (f.o.b.)	−0.4	−0.5	−0.6	−0.7	−0.6	−0.6	[redacted]
Net Service & Private Transfers	[redacted]						
Freight & Insurance	NEGL	−0.1	−0.1	−0.1	−0.1	−0.1	[redacted]
Investment Income Receipts	[redacted]						
Other	−0.3	−0.4	−0.4	−0.4	−0.4	−0.4	[redacted]
[redacted]	[redacted]						
Current Account Balance	0.1	0.1	NEGL	NEGL	0.1	0.3	[redacted]

[1] Estimated.
[2] Projected.

[redacted]

[redacted]

[redacted]

Indonesia:
Current Account

Billion US $

	1974	1975	1976	1977	1978	1979[a]	[redacted]
Trade Balance	1.8	0.6	0.8	2.3	1.8	4.1	[redacted]
Exports (f.o.b.)	6.4	6.1	7.6	9.8	10.2	13.3	[redacted]
Oil	4.2	4.2	5.1	6.2	6.0	8.0	[redacted]
Nonoil	2.2	1.8	2.5	3.6	4.2	5.4	[redacted]
Imports (f.o.b.)	−4.6	−5.5	−6.8	−7.5	−8.3	−9.3	[redacted]
Net Service & Private Transfers	[redacted]						
Freight & Insurance	−0.6	−0.7	−0.9	−1.0	−1.0	−1.1	[redacted]
Investment Income Receipts	[redacted]						
Other	−0.6	−0.9	−1.4	−1.6	−2.2	−2.2	[redacted]
[redacted]	[redacted]						
Current Account Balance	0.8	−1.0	−1.4	−0.1	−1.1	1.0	[redacted]

[a] Estimated.
[b] Projected.

[redacted]

Iran:
Current Account

Billion US $

	1974	1975	1976	1977	1978	1979[a]	[redacted]
Trade Balance	14.4	6.9	9.8	9.0	6.0	12.6	[redacted]
Exports (f.o.b.)	21.6	20.0	23.7	24.5	22.2	20.6	[redacted]
Oil	20.8	19.2	22.8	23.8	21.5	20.2	[redacted]
Nonoil	0.8	0.8	0.9	0.7	0.7	0.4	[redacted]
Imports (f.o.b.)	−7.2	−13.1	−13.9	−15.5	−16.2	−8.0	[redacted]
Net Service & Private Transfers	[redacted]						
Freight & Insurance	−0.9	−1.8	−1.9	−1.8	−2.2	−1.1	[redacted]
Investment Income Receipts	[redacted]						
Other	−0.9	−1.3	−1.4	−1.9	−2.4	−1.3	[redacted]
[redacted]	[redacted]						
Current Account Balance	13.0	4.3	7.2	6.2	2.8	12.3	[redacted]

[a] Estimated.
[b] Projected.

[redacted]

 [redacted]

[redacted]

Iraq:
Current Account

Billion US $

	1974	1975	1976	1977	1978	1979[1]	[redacted]
Trade Balance	3.6	2.9	4.7	5.8	5.1	15.0	[redacted]
Exports (f.o.b.)	7.1	8.7	10.1	11.3	11.2	22.3	[redacted]
Oil	7.0	8.6	9.9	11.0	10.9	22.0	[redacted]
Nonoil	0.1	0.1	0.2	0.3	0.3	0.3	[redacted]
Imports (f.o.b.)	−3.5	−5.8	−5.4	−5.5	−6.1	−7.3	[redacted]
Net Service & Private Transfers	[redacted]						
Freight & Insurance	−0.4	−0.9	−0.8	−0.9	−1.0	−1.1	[redacted]
Investment Income Receipts	[redacted]						
Other	−0.4	−0.3	−1.2	−1.5	−1.7	−2.1	[redacted]
[redacted]							
Current Account Balance	2.9	1.6	2.9	3.8	2.9	12.5	[redacted]

[1] Estimated.
[2] Projected.

[redacted]

Kuwait:
Current Account

Billion US $

	1974	1975	1976	1977	1978	1979[1]	[redacted]
Trade Balance	7.5	6.0	5.8	4.9	5.2	12.3	[redacted]
Exports (f.o.b.)	9.0	8.2	9.2	9.3	10.0	17.8	[redacted]
Oil	8.6	7.6	8.5	8.5	9.1	16.8	[redacted]
Nonoil	0.4	0.6	0.7	0.8	0.8	1.0	[redacted]
Imports (f.o.b.)	−1.6	−2.2	−3.5	−4.4	−4.7	−5.6	[redacted]
Net Service & Private Transfers	[redacted]						
Freight & Insurance	−0.2	−0.3	−0.6	−0.7	−0.8	−0.9	[redacted]
Investment Income Receipts	[redacted]						
Other	−0.3	−0.2	−0.2	−0.3	−0.3	−0.4	[redacted]
[redacted]							
Current Account Balance	6.3	5.4	5.7	4.4	5.0	12.9	[redacted]

[1] Estimated.
[2] Projected.

[redacted]

[redacted]

Libya:
Current Account

Billion US $

	1974	1975	1976	1977	1978	1979[1]	[redacted]
Trade Balance	3.5	1.7	3.7	4.7	3.1	7.3	[redacted]
Exports (f.o.b.)	6.9	6.2	8.6	10.3	9.7	15.2	[redacted]
Oil	6.9	6.2	8.6	10.3	9.7	15.2	[redacted]
Nonoil	NEGL	NEGL	NEGL	NEGL	NEGL	NEGL	[redacted]
Imports (f.o.b.)	−3.4	−4.5	−4.9	−5.6	−6.6	−7.9	[redacted]
Net Service & Private Transfers	[redacted]						
Freight & Insurance	−0.4	−0.5	−0.5	−0.6	−0.8	−0.9	[redacted]
Investment Income Receipts	[redacted]						
Other	−1.0	−1.0	−1.0	−1.3	−1.5	−1.7	[redacted]
[redacted]							
Current Account Balance	2.2	0.2	1.6	3.0	1.1	5.2	[redacted]

[1] Estimated.
[2] Projected.

[redacted]

Nigeria:
Current Account

Billion US $

	1974	1975	1976	1977	1978	1979[1]	[redacted]
Trade Balance	7.2	2.5	3.4	1.7	−1.1	6.4	[redacted]
Exports (f.o.b.)	9.6	7.7	9.7	10.9	9.7	16.9	[redacted]
Oil	8.9	7.1	9.1	10.1	8.7	15.8	[redacted]
Nonoil	0.7	0.6	0.7	0.8	1.0	1.1	[redacted]
Imports (f.o.b.)	−2.5	−5.2	−6.4	−9.2	−10.8	−10.5	[redacted]
Net Service & Private Transfers	[redacted]						
Freight & Insurance	−0.2	−0.8	−1.7	−1.7	−1.6	−1.5	[redacted]
Investment Income Receipts	[redacted]						
Other	−1.8	−2.3	−2.3	−2.3	−1.8	−2.0	[redacted]
[redacted]							
Current Account Balance	5.4	−0.3	−0.3	−2.0	−4.3	3.1	[redacted]

[1] Estimated.
[2] Projected.

[redacted]

[redacted]

[redacted]

Qatar:
Current Account

Billion US $

	1974	1975	1976	1977	1978	1979[1]	[redacted]
Trade Balance	1.7	1.4	1.6	1.2	1.3	2.6	[redacted]
Exports (f.o.b.)	2.0	1.9	2.4	2.4	2.5	4.0	[redacted]
Oil	1.9	1.8	2.1	2.1	2.2	3.7	[redacted]
Nonoil	NEGL	0.4	0.3	0.3	0.3	0.3	[redacted]
Imports (f.o.b.)	−0.3	−0.5	−0.9	−1.1	−1.2	−1.4	[redacted]
Net Service & Private Transfers	[redacted]						
Freight & Insurance	−0.1	−0.1	−0.1	−0.2	−0.2	−0.2	[redacted]
Investment Income Receipts	[redacted]						
Other	−0.2	−0.3	−0.3	−0.4	−0.4	−0.5	[redacted]
[redacted]							
Current Account Balance	1.4	0.8	1.2	0.8	1.0	2.2	[redacted]

[1] Estimated.
[2] Projected.

[redacted]

Saudi Arabia:
Current Account

Billion US $

	1974	1975	1976	1977	1978	1979[1]	[redacted]
Trade Balance	26.4	20.1	23.6	24.1	16.8	33.8	[redacted]
Exports (f.o.b.)	30.4	26.7	34.7	39.7	36.8	58.2	[redacted]
Oil	30.3	26.6	34.6	39.7	36.7	58.1	[redacted]
Nonoil	NEGL	0.1	0.1	0.1	0.1	0.1	[redacted]
Imports (f.o.b.)	−4.0	−6.6	−11.1	−15.6	−20.0	−24.4	[redacted]
Net Service & Private Transfers	[redacted]						
Freight & Insurance	−0.5	−1.0	−2.2	−2.5	−3.2	−3.9	[redacted]
Investment Income Receipts	[redacted]						
Other	−1.0	−3.5	−6.6	−8.3	−12.0	−14.0	[redacted]
[redacted]							
Current Account Balance	23.3	15.4	15.2	13.9	3.8	19.4	[redacted]

[1] Estimated.
[2] Projected.

[redacted]

[redacted]

86-722 O - 82 -62

[redacted]

United Arab Emirates:
Current Account

Billion US $

	1974	1975	1976	1977	1978	1979[1]	[redacted]
Trade Balance	5.8	4.5	5.3	5.3	4.2	7.5	[redacted]
Exports (f.o.b.)	7.4	7.0	8.7	9.9	9.4	13.7	[redacted]
Oil	7.0	6.5	8.0	8.9	8.4	12.6	[redacted]
Nonoil	0.4	0.5	0.6	0.9	1.0	1.1	[redacted]
Imports (f.o.b.)	−1.6	−2.5	−3.4	−4.6	−5.2	−6.2	[redacted]
Net Service & Private Transfers	[redacted]						
Freight & Insurance	−0.2	−0.3	−0.4	−0.6	−0.6	−0.7	[redacted]
Investment Income Receipts	[redacted]						
Other	−1.3	−0.9	−1.4	−2.4	−2.7	−3.1	[redacted]
[redacted]	[redacted]						
Current Account Balance	4.1	3.1	3.6	2.2	1.7	4.7	[redacted]

[1] Estimated.
[2] Projected.

[redacted]

Venezuela:
Current Account

Billion US $

	1974	1975	1976	1977	1978	1979[1]	[redacted]
Trade Balance	6.8	3.3	1.9	−0.5	−1.5	2.1	[redacted]
Exports (f.o.b.)	10.7	8.8	9.1	9.8	9.5	14.3	[redacted]
Oil	10.2	8.4	8.7	9.4	9.1	13.8	[redacted]
Nonoil	0.5	0.5	0.5	0.4	0.5	0.5	[redacted]
Imports (f.o.b.)	−3.9	−5.5	−7.2	−10.3	−11.0	−12.2	[redacted]
Net Service & Private Transfers	[redacted]						
Freight & Insurance	−0.4	−0.7	−0.7	−1.0	−1.1	−1.2	[redacted]
Investment Income Receipts	[redacted]						
Other	−0.7	−0.9	−0.9	−1.7	−2.6	−2.6	[redacted]
[redacted]	[redacted]						
Current Account Balance	6.1	2.3	0.9	−2.6	−4.5	−1.1	[redacted]

[1] Estimated.
[2] Projected.

[redacted]

[redacted]

[redacted]

Finance

Arab Banks More Active in Recycling

Arab commercial banks—many owned by governments—have stepped up their international lending this year but are still not major elements in petrodollar recycling. In first-half 1980, two Arab banks for the first time were among the top 50 Euromarket loan managers. Bahrain-based Gulf International Bank ranked 48th with $818 million in managed loans; Union de Banques Arabes et Francaises (UBAF) of Paris was 49th with $788 million. In contrast, Lloyd's Bank International of the United Kingdom ranked first with loan participations and managements of $10.5 billion. Through the 1970s Arab international banking policy has moved from establishing banking partnerships with Western financial institutions to exclusively Arab consortiums [redacted] The latest major venture in this direction was initiated in January 1980 when the Arab Banking Corporation was set up by Kuwait, Saudi Arabia, and Libya with the largest authorized capital base of any international banking consortium, $1 billion. The bank will emphasize syndicated medium-term Eurocurrency lending. [redacted]

[redacted]

[redacted]

[redacted]

[redacted]

APPENDIX 8.—U.S. GOVERNMENT STUDIES, ANALYSES, MEMORANDA AND OTHER DOCUMENTS DISCUSSING CONCERNS ABOUT, OR IMPACT OF OPEC COUNTRY INVESTMENTS

LIMITED OFFICIAL USE

(Background/Strategy is NOFORN in current form)

Potential Financial Problems for OECD
of Investment of OPEC Assets

Issue: Do OPEC investments of surplus revenues pose financial problems for OECD countries in such areas as:

-- management of monetary policy

-- ability of financial institutions to transform maturities

-- scope for "volatile" transfer of funds from country to country

[COMMENT: This is not a policy issue. It might be raised in the course of the general balance of payments survey as a possible "problem area" (II A) or under the examination of "Problems of the foreign assets of OPEC. . ." (III B). But there is no indication that a G-19 member intends to do so, and it should not be raised by the U.S. This paper could also serve a purpose in G-8 caucuses.]

Suggested Talking Points (contingent)

1. Both the OPEC investor and the private or official recipient in the (presumed) OECD country have legitimate interests in the manner in which OPEC's surplus revenues are invested and managed.

2. In light of recent experience, no particular problems are anticipated because of the various adjustments that have already made or envisaged to deal with the balance of payments problems posed by the OPEC surpluses.

3. The investment of the burgeoning OPEC surpluses in 1974/1975 progressed rather smoothly, despite some forecasts of catastrophe. Most of the flows were handled through the private market, and only modest reinforcement of cooperative financial arrangements was deemed necessary.

4. OECD managers of domestic monetary policy may have had additional factors to take into account, but so far the inflow and maintenance of OPEC assets do not appear to have caused serious problems in this area.

5. Despite significant strains placed on domestic and Euro-banks in their role of maturity transfromation -- as a result of the heavy concentration of OPEC assets in short-term deposits compared to oil importing countries' demand for longer-term funds -- they were able to manage the flow of funds from

oil exporting countries. We believe that what difficulties emerged mainly reflected problems in individual banks, rather than the system as a whole, and probably were connected with the downturn of economic activity.

6. Nor have there have been serious problems arising from the scope for "volatile" movements of the stock of OPEC assets from one country to another. The absence of such shifts is understandable from the point of view of the OPEC since:

-- there is not a large range of alternative financial assets which could readily absorb such large amounts of funds;

-- any large scale movement would probably induce significant exchange rate change which might well be reversed following completion of the shift, thus resulting in significant costs

7. In general, we are satisfied with the manner in which OPEC assets have been invested and maintained. While we will of course keep the situation under review, from the point of view of OECD interests, we see no need for any additions to arrangements within the OECD or vis-a-vis the OPEC countries beyond those now existing or contemplated.

Background/Strategy

Following the sharp rise in oil prices, we were faced with expressions of great concern about the financial impact on developed countries of large accumulations of funds by the OPEC. These concerns were voiced largely outside governments, but some leading foreign officials also joined the forecasts of "gloom and doom" for financial systems in the West, and the highly-publicized failure of some banks was attributed to metaphoric "waves of petrodollars". The U.S.G. attempted to place in perspective concerns regarding the financial impact and to highlight what we saw as the more significant real impact of higher oil prices -- on economic growth, employment and inflation.

This was largely an intra-OECD debate, as the OPEC strategy was in part aimed at minimizing the damage to oil-importing economies of their action on prices. With the passage of time, the U.S. point of view regarding the inherent ability of the market place to cope with unexpected shocks gained general acceptance. The range of issues involved was addressed in the OECD's Temporary Working Party, and CPE/TWP (75)10 (1st Rev) incorporates a generally agreed analysis of the situation, as well as agreement that additional official financing arrangements (global or OECD) or special cooperative arrangements with the OPEC are not necessary. The OECD countries in a weaker external position -- mainly the smaller countries plus some of larger -- were anxious not to foreclose additional financing mechanisms, and so the final TWP Report reflects a more cautious tone of optimism than the U.S. would have preferred.

Accepting an analysis highlighting the potentially destabilizing impact of the investment or transfer of OPEC funds would be tactically unwise, as well, since it would tend to enhance OPEC's bargaining power. Participants in the CIEC, perhaps including some of the G-8, would see merit in schemes for tying up surplus OPEC revenues by such means as issuing special long-term debt instruments or establishing mutual fund/investment bank facilities for direct investment. If the act of tying up OPEC funds is seen per se as beneficial to the developed countries, then the OPEC will push harder for concessions (e.g., favorable yields, indexation, guarantees) and the OECD countries will be more ready to grant them.

Treasury
OASIA/IMA: (JML)
3-11-76
Rev. 3-15-76

Clearances: Treasury:		Mr. Widman (draft)
"	:	Mr. Griffin
FRB	:	(no comments received)
CEA	:	" " "
State	:	" " "

ISSUE:

Ability of OPEC and other foreign holders of U.S. assets to influence U.S. policies.

APPROACH:

-- There should be no fear whatsoever that foreign direct or portfolio investment in the U.S. (including foreign holdings of government debt instruments) implies some potential influence over U.S. ability to chart its own economic, defense or foreign policies.

-- This applies specifically to OPEC assets in the U.S. which amounted to less than 15% of the roughly estimated $290 billion in foreign assets held in the U.S. at the end of 1977. (This compares to approximately $380 billion in U.S. assets held abroad.)

-- The growth and general stability of foreign assets in the U.S. indicates that these investments are based primarily on economic and financial motivation.

-- We have strongly supported the development of a free and open international flow of investment as a principal cornerstone on which progress and cooperation in international trade, investment and finance are based.

-- Extensive analysis on the levels and trends of foreign investment in the U.S. conducted by the Executive Branch has supported our open and liberal policy but developments in this area are of course continually watched.

Office of International Banking
and Portfolio Investment
June 19, 1978

[CIA document previously published in 1979]

June 1978

Saudi Arabian Foreign Investment

Temporary dislocation of international financial markets would ensue, if the Saudi Arabian government ever chose to use its accumulated wealth as a political weapon. Official Saudi foreign asset holdings totaled $63.6 billion at yearend 1977. In comparison, at yearend the international reserves of the United States were $19.4 billion and of West Germany were $39.7 billion. The Saudis have distributed their official asset holdings widely among major banks in industrialized countries. The Saudi Arabian Monetary Agency (SAMA) has approved more than 50 banks as repositories for official Saudi investment funds. (S/NF)

The composition of the Saudi portfolio at this time limits its use as a political weapon. Since Saudi surplus funds are heavily concentrated in a few countries and in US dollar assets, any politically-motivated shift out of the US dollar could involve heavy financial losses for the Saudis. If such action depreciated the value of the US dollar, the value of the Saudis' accumulated holdings still in US dollars would decline. Due to the magnitude and structure of their US dollar holdings and the more limited investment opportunities in other currencies, Saudi Arabia would still have large dollar assets, even after a major shift attempt. (S/NF)

Before using its petromoney to secure political goals, Saudi officials would also evaluate the possibility of retaliation and the effectiveness of using money as a weapon. The Saudis would face the possibility that: (1) the US government would freeze Saudi asset holdings in the United States, and (2) in the future banks would be unwilling to pay competitive interest rates on Saudi deposits. The Saudis also realize that the effectiveness of the petromoney weapon is limited by the integration of the international financial system. Funds shifted from one country or currency to another may flow back to that country or currency through the international financial system if need (and hence rate of return) is greatest there. In a similar manner, a large share of OPEC investment of petrodollars in the developed countries flowed through the international financial market to the less developed countries because of their need to finance large oil-induced trade deficits. In the United States, as elsewhere, the Saudis refuse to acquire controlling interests in companies or to invest in real estate; possible capital losses make these investments unattractive to the financially conservative Saudi government. (S/NF)

Information on the size and distribution of private Saudi foreign investment is scarce. Investment by private Saudi individuals and corporations may be more destabilizing than official Saudi investment, because individual investors may be more willing to undertake risky or speculative investments than the government. Even though private Saudi investment may be more volatile than official investment, it is even less likely that the investment decisions of private Saudi citizens give ~~s~~ appreciable weight to political leverage. (S/NF)

[Subcommittee note: This is a copy of a Federal Reserve document.]

Mr. Bryant — Conversation with Banker

Samuel Pizer

STRICTLY CONFIDENTIAL (FR)

I happened to talk to a representative of a second major bank this morning and pursued some of the questions I reported on in yesterday's memo on this subject.

1) This banker tended to minimize the extent of the inflow of Arab funds up to this point, saying that a good deal of it had tended to "disappear." By disappearing he meant that at his bank they were seeing sizable payments being made to some of the less affluent Arab countries, and he suspected a sizable amount through April had been used to cover the cost of arms bought from the Russians.

2) His bank (and the suggestion was that perhaps other banks as well) were getting concerned about credit risks in Europe for countries other than Italy, and, of course, they had plenty of concerns with credit risks elsewhere. One approach of this bank to solving the problems of excessively risky loans was to act in effect as an intermediary between the borrowers and the financial agencies of the Arab countries -- specifically SAMA in this case. What the bank does apparently when its own credit line has been over-extended is to take a request for credit to SAMA or perhaps some other agency of the oil-producing countries and offer the business directly to the sources of funds. It seems doubtful that this sort of thing has

happened yet on a large scale but this banker seemed to think that there was a considerable potential for handling the problems of risky loans through this procedure. At the same time it was recognized that the monetary agencies of the oil-producing countries will also reach the limit of their willingness to extend credit to some of these borrowers.

3) This bank was not as forthcoming in stating the terms offered to the oil producers for overnight funds but I understand that in a second conversation with Ralph Smith later in the day the impression was left that the posted rates for overnight funds do not represent the rates actually paid to these depositors.

4) On the question of diversification of oil producers' assets, this banker seemed to think that some diversification would be coming fairly soon, particularly in the form of U.S. Government obligations.

SP:tn
5/21/74

cc: Mr. Reynolds
Mr. Wonnacott
Mr. Gemmill
Mr. Smith

to Jerry Newman

room 5416 date 4/1

Department of the Treasury

Office of the Assistant Secretary (Trade, Energy, and Financial Resources Policy Coordination)

Office of Energy Policy Analysis

IMA prepared this language which I transmitted to State today for inclusion in PRM 10.

Director
Charles Schotta
room 4464
ext. 5071

DECLASSIFIED
AUTHORITY:
DATE: 8/17/79

The OPEC investible surplus, largely concentrated in the Persian Gulf countries--Saudi Arabia, Kuwait, and the UAE, poses little positive threat to US interests. US concern with the potential economic effect of OPEC surpluses lies in three areas:

-- effects on global economic stability;

-- effects on the international financial system;

-- effects on the US financial system.

The effects on the global economy are summed up in the so-called "recycling" problem--attaining a pattern of current account balances among the oil importers which can be financed without resort to measures such as trade and capital controls.

The OPEC can contribute by 1) providing aid--grants or loans--in larger amounts to a wider range of countries (though this can lead to dependency situations not in our interest); 2) lending to, e.g., the IMF, so as to increase the availability of balance-of-payments financing via that channel.

The harmful actions would largely be restricted to abrupt, large-scale shifts of funds among national capital markets--at present, their investments are largely of a portfolio nature. Such shifts would be harmful to individual countries, but would also be harmful to the OPEC. Thus, unless political factors were overriding, it would thus not seem in OPEC's interest to use their accumulated wealth in this manner. As the size of their assets increase, so does their stake at the system.

Under present circumstances, there is little possibility for such flows to occur. Capital markets outside the US and U.K. are simply not open to such large flows--or would be only on terms (including the potential exchange rate effect) which would make them unattractive.

The U.K. is now protected by the Basle agreement. With regard to the US, two aspects of this problem can be posed. What is the probability of a massive withdrawal of these deposits? Secondly, if withdrawn, what would be the damage?

The oil producers in the Middle East are very unlikely to withdraw deposits on the US in concert. They have quite independent investment policies and quite diverse policies with respect to the US. Also, to do so would seriously damage their relationship with the US government and with the very banks whom they have selected as best able to profitably hold their funds.

In any event, if massive withdrawal--the worst case--were to occur, only minimal damage to the US would result, namely a modest increase in the cost of funds to certain huge US banks. If one or more of these key OPEC nations were to transfer their funds to non-US banks, those banks in essence would offer them to the interbank market where US banks would go to borrow at a slightly higher cost. In effect the US banks would be paying, e.g., the U.K. banks a small commission for these prior cost of obtaining these funds directly. Also, it is likely that Arab investors will receive a slightly lower return as they share the extra cost with US banks of dealing only indirectly with US banks.

Thus, any such sudden withdrawal would be unlikely to affect the US economy as a whole, although individual banks losing deposits might be unfavorably affected.

[Subcommittee note: Treasury Dept. deleted names of bank officials and their banks.]

Date: August 7, 1974

MEMORANDUM FOR: Under Secretary Bennett
Assistant Secretary Cooper

From: Thomas D. Willett TDW

Subject: Report on Discussions with New York Bankers Concerning Prospective Problems in International Financial Markets

I thought you might find of interest the attached report by Dirck Keyser.

cc: Messrs. Fiedler, Parsky, Cross, Widman,
Pelikan, Springborn, McCracken

Attachment: LIMITED OFFICIAL USE

	Initiator	Reviewer	Reviewer	Reviewer	Reviewer	Ex. Sec
Name	WILLETT					
Init. / Date	/	/	/	/	/	/

[illegible] Treasury

OPTIONAL FORM NO. 10
MAY 1962 EDITION
GSA GEN. REG. NO. 27

UNITED STATES GOVERNMENT

Memorandum

Department of the Treasury
Washington, D.C.

TO : Thomas D. Willett

DATE: August 5, 1974

FROM : C. Dirck Keyser CDK

SUBJECT: Contingency Planning: Consultations with Bankers

In recent conversations with bankers during the period from July 23 to July 30 (including visits to seven New York banks July 25 and 26), we found their concerns generally fell into the following categories:

(1) Bank failures and Euromarket liquidity;

(2) recycling problems;

(3) problems foreseen for individual countries;

(4) deflation; and

(5) inflation.

Several of those with whom we talked (notably Mr. at the New York Fed, Mr. at , and Mr. at) indicated that the bank failures are not necessarily linked to the recycling problem. The areas of concern are discussed below.

1. <u>Bank Failures</u>

The problem of bank failures has received a certain amount of attention in the press recently (see attached articles), and was uppermost in the minds of three of the bankers with whom we talked -- Mr. in the Foreign Department of the New York Fed; Mr. , head of the international department at ; and, in a somewhat mixed fashion, Mr. , financial planning and monetary economist to Executive Vice President of . It was mentioned by several others.

's concern about the problem, perhaps professional since he views this kind of worrying as part of his job as a central banker (he is known to be somewhat alarmist), was the most dramatic, and a copy of a memorandum of conversation with him is enclosed. He said that the June 26 col[illegible] of the

Bankhaus I. D. Herstatt of Cologne had made an international financial panic possible, partly because it was the ninth in a series of bank crises beginning with the collapse of the United States National Bank of San Diego last fall, the difficulties of the British "fringe banks" last winter, and those of the Franklin National Bank this spring. He knew of several potential Herstatts, he said, and he indicated that he considered the danger period of possible panic to extend to October. New York international transaction volume had shrunk from $65 billion a day before Herstatt to $30 billion a day since, and the market for bankers' acceptances had dried up.

of , while more low-key, also termed it the most serious problem on the horizon, and also said a number of banks were "walking wounded."

Mr. ,a vice president and international economist with , regarded the problem as less serious (the bank economists generally seemed more optimistic than the loan and operations officers). He noted, however, that the failure of the Israel-British Bank of Tel Aviv on July 9 had raised a question as to the support the central banks are prepared to give, since it has been reported that Israeli authorities have argued that the London office is a subsidiary subject to British regulation rather than a branch controlled by the parent in Israel, and have been unwilling to provide the backing, while the Bank of England has argued that the subsidiary is indeed controlled by the parent, and so have also refused to help.

This leaves the impression that there may be no lender of last resort backing many of the London banking offices which conduct the bulk of the Eurodollar business, and, if true, would probably be a proper cause of concern. However, the fact that the Israeli-British office in London is a subsidiary rather than a branch is relevant, in the eyes of some in the Federal Reserve Board staff here, one of whom points out that the foreign branches of U.S. banks control some $120 billion in assets, while the foreign subsidiaries, many of which are engaged in peripheral banking activity such as leasing, control only about $10 to $15 billion in assets. The Fed and the Bank of England apparently stand behind the branches fairly unequivocally, although as another Board of Governors staffer points out, no central bank can write a blank check in advance. This same staffer says that the Bank of Japan has also made commitments, and that the Fed, the Bank of England, and the Bank of Japan between them cover the bulk of the world's banking assets. The Bundesbank, which has drawn considerable criticism from New York banks for failing to cover their losses in the Herstatt affair, was not directly involved in that situation, according to the Fed staff, and has strengthened its commitments (within the general "no blank-check" limitation) since. Moreover, the losses incurred by the Herstatt trading partners may be halved when the dust settles.

The banks damaged by Herstatt's collapse suffered primarily as a result of having sold foreign exchange to Herstatt for same-day settlement on the day the bank was forced to suspend operations, so that they did not receive the payment due after delivering on their side of the contract. Federal Reserve officials are inclined to be somewhat less than fully sympathetic because, they argue, Herstatt had outstanding obligations -- including the obligations to deliver against the same-day June 26 contracts -- far in excess of their assets. Even if they had made good delivery on the same-day contracts, it is said, the checks might subsequently have bounced.

The Eurodollar market is unregulated and largely based in London, so the Israel-British case is relevant. Similarly, the failure of the oral contracts involved in the United States National Bank of San Diego and the Herstatt cases are damaging to confidence, since most Eurodollar transactions have been inter-bank deals made orally on the strength of bank names rather than on the basis of any serious credit investigation. The San Diego and Herstatt cases have spread gloom, bitterness and mistrust.

The effect has been to diminish the volume of trading in the Eurodollar market considerably, particularly since there has been some central bank pressure to do so. Banks have become more cautious about whom they deal with.

The same caution has spread to non-bank depositors, and   , for instance, already stung in the past, have reportedly cut the list of banks in which they are willing to make deposits from 35 to 30 after the Franklin National difficulties. They have also been most reluctant to buy certificates of deposit in maturities longer than one month, a factor complicating the recycling problem, discussed below.

The mistrust of smaller banks by petroleum exporters and by other banks has of course increased the difficulty the smaller banks have getting deposits. The maturity structures of their assets and their liabilities further complicate matters for them, since the most common Euromoney market deposit has been the three-month CD, while many of the banks' outstanding loans have maturities as long as three, six, and even ten years. The liquidity of these smaller banks would be threatened if their flow of deposits were to begin to dry up, as to some extent they are now doing. of the Federal Reserve Board staff says it is almost impossible to exaggerate the difficulties of smaller regional banks, which are experiencing great difficulty borrowing money, either in the form of deposits or in other markets.

The possibility of snowballing bank failures, such as occurred when the Credit-Anstalt went under in 1931 (and Credit-Anstalt's outstanding foreign obligations were only about $100 million as compared with over $156 million for Herstatt), is presumably a part of the concern expressed by and others, and the doubts about the reliability of lender-of-last-resort support to banks' London offices contribute to commercial bankers' concern. Since the Eurodollar market is today the supplier of a good deal of the world's banking liquidity, the most pessimistic observers think in terms of the implicit worldwide deflationary threat.

It is thus reassuring that the more optimistic views include that of former CEA Chairman Paul McCracken, who notes in his Wall Street Journal article (attached) that the number of failures we have seen in the past 11 months is far less than took place in 1929, when they numbered 659. Similarly, 's assistant at observes that perhaps the scare of a few failures has led to a healthy tightening up of lending and deposit-acceptance policies by Euromarket banks, and has actually improved the quality of that market. of said he was "reasonably optimistic" about the liquidity of individual banks and their ability to meet their problems. Even , the most pessimistic of all those we talked too, spoke only of the possibility of crisis, not its probability.

2. Recycling Problems

The recycling of oil payments, or petrodollars, is the problem uppermost in the mind of , senior vice president of (memorandum of conversation attached) and apparently, to judge from 's allusions and various news stories, in the mind of Chairman It is a subject which also came up in conversation with bankers at and elsewhere.

Basically, 's concern seems to be that funds will be accumulated by the Arabs beyond their ability to spend or invest them, and that the draining of these funds from the oil importors to the oil exporters will have a deflationary effect on the world economy.

In fact, the Arabs received payment in New York dollar deposits, which are redepositied into the 30 or so banks they trust in the Eurodollar market, primarily in the shortest maturities, where, as long as the Euromarket retains its viability, they are available for loans to oil importers suffering from liquidity problems. Moreover, although this point was not apparently understood by Mr. , the Eurodollar deposits are of course backed by New York dollar deposits, so that the original underlying dollar deposits never leave New York or the U.S. domestic money supply, even though their ownership changes from that of a U.S. oil company to that of an Arab government or Eurodollar bank.

Focussing on the problem confronted by the commercial banking system, Mr. said that the ability of the banks to accept interest-bearing Eurodeposits in extremely short maturities -- call money, seven-day money, one-month money -- was rapidly being exhausted (could continue at this pace only six or eight months longer, he said), since the banks must manage the risk attached to overconcentration of deposits just as they must that of an overconcentration of loans. Among the risk management factors they must consider are deposit-to-equity ratios. Moreover, since their loans are generally of longer maturity than the maturities sought by the Arabs for their deposits, the banks' risks were multiplied.

was accordingly seeking to discourage further call-money deposits by the Arabs, and offering call-money interest rates below the market. The bank had had some success in getting the Arabs to accept six-month maturities, but the bulk of the Arab deposits, even at lower interest rates, continued to be in call money.

This same problem of the strain on the capacity of the major banks was raised by and by , as well as by , where a bank economist told us that the operational officers were becoming a little concerned over the composition of assets. A loan officer said that while his bank does not yet have too much liquidity, this was the trend.

Both contacts and at expressed high confidence in the ability of the markets to recycle the funds. at was reported to us to be "reasonably optimistic."

felt it most important that as much of the Arab money be rechannelled into long-term investment as possible in order to take the pressure off the commercial banks. He did not believe that the Arabs had as yet done much portfolio investment, and said that they were in fact being inundated with proposals for foreign direct investment and domestic development. was selling management services to the Arabs to help them sort out the proposals, but here again, he felt that the ability of the private sector to deal with the problem was rapidly being outrun, and he felt that the Government would have to do something, as he assumed Secretary Simons was.

at the New York Fed reports that he is managing a fairly large petrodollar portfolio, primarily on behalf of and , but also including of money, only $1,100 of which is in cash. The funds had begun to come in in March.

3. <u>Problems Foreseen for Individual Countries</u>

Although the problems foreseen for individual countries are here separately analyzed, they are in effect a subset of the recycling problem, since the countries involved are all oil importers, and the problems all arise from expected balance of payments difficulties. The countries mentioned as having potential problems of a serious nature are as follows:

(1) Italy;
(2) United Kingdom;
(3) France;
(4) Japan;
(5) South Korea;
(6) Bangla Desh; and
(7) Sri Lanka.

The most serious worldwide problem foreseen that could arise from individual countries' balance of payments difficulties was that most, and particularly Japan and France, were expected to make every effort to restore their imbalance of payments to some kind of balance, if necessary by "beggar-thy-neighbor" policies. Mr. s assistant at said that the current buzz-word in Europe on this subject was "more equitable sharing of current account imbalances," a code for a package approach involving:

(1) loans from the countries having smaller balance of payments problems to those having larger problems;

(2) toleration by the international community of the use of export subsidies by the more severely affected countries;

(3) similar tolerance of import restrictions by the more severely affected;

(4) internal deflation by the more severely affected; and

(5) use of pegged exchange rates.

He agreed that one serious worldwide problem which could arise was a general reduction in world trade arising from competitive devaluations and similar attempts to manipulate trade flows and current balances, which in turn could trigger worldwide deflation. This was viewed as a real risk, perhaps the most serious problem of all, by , international economist at of also considered this a serious problem.

Some felt that the problems confronted by Italy, France, or the United Kingdom could be so serious as to provoke internal or external violence. at suggested that some Europeans could become so desperate as to attempt conquest of oil resources from the Arabs, and he said that such solutions come up after the first five minutes of a European conversation on the subject, and that the Arabs were very aware of that risk. , bank economist at , who was one of the cheeriest of the men we met, when pressed for problems suggested this one. at , a German, said he feared the resurgence of "Fascist brigades" in the streets if economic problems reached the point of hunger.

It seemed generally agreed that the most serious problem was that of Italy, although 's assistant at suggested that Italy was in a position to "blackmail" the other OECD nations by brandishing the horrors of Italian chaos if assistance is not forthcoming. bankers seemed to think similarly: the other powers could not let Italy go under. A similar view was expressed by of .

of said that it was not possible that Italy and France could avoid a major balance of payments problem, a deficit which would carry through to about the year 2000. He believed that the only feasible solution would be for the Arabs to finance these two countries for that length of time.

While at , the bankers, and at all expressed concern about the less developed countries, at said that he was not particularly concerned about them, since their sufferings seemed unlikely to be translatable into world chaos. had seemingly done more thinking about this aspect of the problem, and said that Bangla Desh and Sri Lanka were in real trouble. would simply not lend to such credits. He had a man studying South Korea, and believed there was a serious question about the economic viability of South Korea in about two years.

4. <u>Deflation</u>

A recurring theme in bankers' statements of their concerns was the possibility of worldwide deflation. Some thought that it could come about through the deflationary effects of Arabs' holding funds rather than recycling them, as suggested by at ; this was also seen as a possibility by at , but it is interesting that he added that he did not think that this would be likely to bring on a worldwide deflation (, incidentally, seemed somewhat more sophisticated, economically speaking, than did).

More frequently the possibility of worldwide deflation was seen as an outgrowth of attempts by oil importing nations to keep their current accounts in balance, as discussed in section 3 above.

at and at both said they expected a worldwide recession, without specifying why he thought so. said he foresaw a dramatic slowdown in world economic growth through the remainder of 1974 and 1975, which he said would be caused by a decline in real balances.

5. Inflation

, 's assistant at ,
said that in his opinion the most serious problem may be that of worldwide inflation. The most serious financial effect of inflation, he felt, was the jeopardy in which it placed the long-term capital markets. It is now almost impossible to raise money by long-term bond issues or by equity offerings. If inflation were to get out of hand -- in excess of 20% per annum -- there might be some kind of collapse in some countries, perhaps brought on by stern governmental counter-inflation policies.

Attachments

cc:
G.H. Willis
R.V. Korp
C. Schotta
D.J. Klock
J. Burns
D. Sweeney
R. Fauver

MEMORANDUM OF CONVERSATION

Participants:

, Foreign Department, Federal Reserve Bank of New York
C. Dirck Keyser, Treasury/OASIA
, Treasury/OASIA consultant

Asked what his current problems were, Mr. said that ever since the failure of the Bankhaus I. D. Herstatt on June 26 there has been a possibility of panic; he felt that all the ingredients for financial chaos were there, and estimated that we would not be out of the woods until about October 26. He did not think that such a crisis would necessarily ensue, only that it was possible, and he felt that it was encouraging that we had successfully gotten through the month since Herstatt's failure. Nevertheless, the risk remains, and he knows of several potential Herstatts that he worries about.

The Herstatt collapse was significant in part because it was the ninth such crisis since last fall; he recited the list, which included United States National Bank in San Diego, the British "fringe banks" in December 1973, and Franklin National Bank in New York. He emphasized that these problems had nothing to do with the "petrodollar" problem, but had arisen for other reasons: people speculating in foreign exchange markets beyond their capital capacity, bad management, and making bad loans.

As a quantitative indicator of the post-Herstatt atmosphere, noted that the volume of international transactions handled through New York before the Herstatt failure had averaged $65 billion a day; since Herstatt, it had been only about $30 billion a day. Banks were becoming very careful, very cautious -- which was, of course, a good thing. The bankers' acceptance market had dried up, and this was why there had been a $240 million decline in bankers' acceptances reported by the 12 leading New York banks during the week ending July 24, he said; smaller banks were finding it difficult to place acceptances with the larger banks, he said, and were as a consequence simply carrying these credits themselves rather than laying them off in the market as acceptances.

He said that he felt that the Treasury did not appreciate the seriousness of the situation, and he wanted to make sure that it was understood. Asked what the Treasury was doing (or leaving undone) that evidenced such an attitude, or what posture he would like to see the Treasury adopt, he was at a loss, and said that he could think of nothing the Treasury could do at the moment that would help, but that nevertheless, he wanted to make sure that the situation was understood. He emphasized that he was not predicting a crisis, merely saying that one was possible, and he hoped the Treasury would be ready to help if some concrete action were to become needed.

The New York Fed, he said, was placing bank rescue at the top of its priorities, as was the Bank of England. The Fed was ready to back any bank which is otherwise well-run but which runs into substantial liquidity problems. He hopes that the Treasury will recognize in such a case that if a temporary expansion of reserve aggregates is necessary, it will be done, even if it goes against inflation-control policy for awhile.

The petrodollars, which did not have anything to do with the foregoing, had only begun to come in within the past three months. Most of the funds which the New York Fed had received in recent weeks had been from and . He is now managing a very substantial petrodollar portfolio. The have on deposit with him, of which only $1,110 was being held in cash; he agreed with Mr. 's remark that there would be no problem with velocity in this circumstance.

July 26, 1974

MEMORANDUM OF CONVERSATION

Participants: , Senior Vice President,

C. Dirck Keyser, Treasury/OASIA
, Treasury/OASIA Consultant

Mr. told Messrs. that he viewed the oil payments problem as quite serious. In explaining it, he used the analogy of a flood control project, observing that the world is now perforce full of amateur flood-control engineers. The commercial banks represent the first line of defense, or set of "reservoirs". The cut their list of banks from 35 to 30 after the Franklin National Bank ran into difficulties. The banks, he pointed out, must be as concerned about the concentration of ownership of deposits as they are about concentration of loans. The alone will have to deal with in 1974 -- the flood of money began only in March -- and this can exceed the deposit capacity of the 30 chosen banks. itself is accepting deposits in London reluctantly, and has been telling the Arabs that the bank is unable to accept more call money except at a discount from the market rate of interest (he mentioned a 6% discount, which seems like a lot; elsewhere we heard 1/2%). Despite this discount, the Arabs continue to insist on call deposits, although they are increasingly willing to talk in terms of six-month deposits -- about a quarter of the new deposits are now in the six-month maturity, he said.

The second series of "reservoirs" described as being domestic development and foreign direct investment projects. The Arabs are inundated with project proposals, he said, and are hiring the best managers and advisors they can to help them sort out the wheat from the chaff. is helping in this winnowing process, he said. By and large, portfolio investment is not significantly under consideration at this stage, and although U.S. companies are watching purchases of their shares very carefully for just such a development, it does not appear that there has been much in the way of portfolio investment here so far.

The third line of defensive "reservoirs" indicated would be necessary in his view would have to be U.S. governmental action, and he indicated that he felt that Secretary Simon understood this point and was taking appropriate action in his visit to the Middle East. Treasury Specials would be in order, as would be multilateral international institutions.

emphasized that he viewed the nature of the problem which would have to be solved by his three classes of "reservoirs" was that of recycling, a problem which he felt would go beyond the capabilities of the thirty banks the Arabs were willing to trust (, he said, could not absorb deposits at the present pace for much longer than six or eight more months), and which so far had exceeded the capabilities of the second category of financial "reservoirs", the development and direct investment projects. Since these first two classes of "reservoirs" would be unable to contain the flood, it was absolutely necessary that the third class be brought into play as soon as possible. He said this was necessary for two reasons: first, because the accumulation of funds in the hands of the Arabs, if not gotten back into circulation, would be deflationary, and second, because the Arabs were not putting any significant amounts into the less developed countries, being unwilling to accept the risks involved.

He emphasized that in dealing with the Arab governments, one is essentially dealing with family enterprises of an extremely conservative nature, and that it is very difficult to win their confidence to the point that negotiations can be fruitful. They had been burned in dealing with a number of Western investment promoters, and they were therefore proceeding very cautiously in dealing with the flood of advice they were now receiving. It takes months, if not years, to win their confidence, and it would not be possible for Secretary Simon to reach this stage with them on his first visit. As soon as Secretary Simon finished talking with them, they would immediately discuss what he had said with people they had known and trusted for some time, including many of the financial people in New York.

Another risk saw if the recycling doesn't begin massively and quickly was that a number of the European countries involved, such as Italy and France, would become desperate. He noted that it had taken 45 minutes for our conversation to come around to the discussion of the use of force against the Arabs, but in Europe the subject comes up in five minutes. The Arabs are very conscious that they face this risk, and he hopes that they will take it into consideration in policies.

Messrs. Keyser and tried to discuss the question raised by Mr. of the deflationary risk involved in a failure to achieve adequate recycling. They pointed out to him that the Arabs were being paid in New York dollar deposits, and their ownership of these deposits did not really remove them from the U.S. money supply. Mr. seemed unable to grasp this point, and insisted that the Arabs' deposits in the London branches were subject to British regulation, should any regulation be adopted, and belonged in London; they could not be pulled back to New York at the whim of the parent banks.

Mr. made frequent references during his conversation to as , saying that was very concerned about the recycling problem.

A Brief Guide to Oil-Related Financial Problems

1974

OASIA/Research

I. Magnitudes and Mechanics

A. Magnitudes

Most forecasts of the OPEC current account surplus for 1974 lie in the range of $55-65 billion. The size of the potential swing in OPEC oil revenue and current account balances can be seen in Table 1. 1/

This surplus represents the magnitude of the funds OPEC will have to invest, and which the rest of the world will use to finance its corresponding deficit.

How these flows will be handled by the markets, where the funds will eventually come to rest, and what (if any) relationship they will show to requirements for financing current account deficits on a country-by-country basis constitute the core of the recycling problem.

B. Mechanics

The impact of the overall flows of OPEC capital on payments balances is exceedingly complicated.

How the various balances are affected will depend on such factors as what type of accounts the funds are invested in, whether or not the funds are identifiable as official.

1/ Given the enormous uncertainties involved, Tables 1 - 4 should be taken as illustrative of orders of magnitude only.

A variety of possible combinations of type of asset/provenance of flows is shown in the attached set of tables. 2/ As will be seen, the range of possible ways flows of OPEC funds may be reflected in the b/p statistics is very wide -- so wide that the traditional interpretation of these balances comes into question.

II. Delineating the Various Oil-Related Problems

A. General Systemic Problems

1. Strains on Private Financial Markets.

The magnitude of the flows of capital which the OPEC will be investing, coupled with OPEC preference to date for short-term bank deposits, have raised questions as to the ability of the private financial markets to handle them. Among the fears are the following:

-- OPEC portfolio preferences may be sufficiently different from those of other market participants that intermediation will be much more complex. For example, if OPEC funds tend to be short-term, banks will be taking more risk for any given volume of long-term lending; this may at a minimum widen the spread between short and longer term rates.

2/ "Case 1" etc. These tables were worked out by Don Curtis.

-- OPEC deposits will be very large, so that only large banks and capital markets can absorb them. As a result, there may be destabilizing flows of funds from smaller banks and money markets to the largest ones in London and New YOrk. This tendency may be exacerbated to the extent that uncertainty as to responsibility for international banks (e.g. Anglo-Israel) causes non-OPEC funds to also move in this fashion. Thus there is a possibility that a number of smaller banks could be confronted with severe deposit drains and/or the necessity of paying higher interest rates to depositors; this is turn could force them to increase the riskiness of their loan portfolios in order stay profitable.

Finally, given the distribution of deficits, private assessment of creditworthiness may not correspond with needs for borrowing to finance current account deficits; this problem is discussed under (2) and (3) below.

2. Need for Concessional Finance for MSAs.

The so-called "Most Seriously Affected" (MSA) countries are generally countries (e.g. India, Pakistan) which were experiencing severe experiencing severe payments imbalances even before the oil crisis. Most of these LDCs are affected not only by higher oil prices but also by higher prices for oil-based products such as fertilizer which are essential to their development plans. These countries are characterized by severely limited ability to transform their domestic economies in response to the altered situation, and their ability to borrow in international capital markets was very limited even pre-oil.

Thus if they are to get the financing needed to cover their increased import payments, it is highly likely that official efforts by some combination of industrial and OPEC country governments will be required to channel the necessary funds. The funds will need to be on concessional terms, since most if not all of the MSAs already have severe debt service problems.

3. Financing Current Account Deficits of other Oil-Importing Nations

As a result of higher oil prices, virtually all of the major OECD countries, and most of the LDCs (other than MSAs) will be experiencing current account deficits, and will need to borrow abroad to finance them. The problem is that some countries may attract more capital than is required, (the problem of "over-borrowing"), while others may be unable to borrow sufficient sums in the private capital markets.

For example, several possible theoretical models for distribution of investments among markets (e.g. proportional to size of market), would suggest that the U.S. would attract a disproportionately large share of available international flows. This in turn would require either some way of rechannelling the excess back out, or running a much larger current account deficit, if excessive pressure on other countries to adjust is to be avoided. On the other hand, Italy appears to have substantially exhausted its ability to borrow except from governments, and there are reports that banks are placing ceilings on loans to Japan.

In the Japanese case, however, they have announced a current account target for 1975 (more properly a desired adjustment to their current account by mid-75) which would imply a substantially increased financing burden for other oil importing countries. This gets into the question of consistency of current account objectives among major countries, which is discussed below.

4. Obtaining Consistency in Current Account Positions in a Non-Disruptive Manner

As can be seen in Table 2, the current outlook for the distribution of current account deficits among the major OECD countries is highly lopsided. As noted above, several of the countries with the largest projected deficits are already experiencing difficulty in borrowing in private capital markets. In addition, the Japanese and French have announced intentions to substantially reduce their deficits within the next year or so. In the Japanese case, the intended adjustment is very large indeed (cf Table 3); the yen is already down 10% from its level of late last year.

The Dutch, on the other hand, have indicated a desire to reduce their current account surplus (primarily for domestic reasons, however; we discuss domestic policy aspects in the next section).

The magnitude of the potential problem in reconciling current account aims can be seen in Tables 2 thru 5. These tables show some illustrative calculations of how the world deficit vis-a-vis OPEC may be distributed under various scenarios.

These distributions fall under 3 general headings:

(a) Status Quo - maintenance of existing exchange rate structure and absence of major adjustment actions by national governments.

[Treasury Deletion]

(b) Decentralized or Uncoordinated Adjustment Action - Countries consult their own preferences as to whether they seek adjust their current account balances or simply finance their current account deficit. Table 3 illustrates several possible distributions of deficits, assuming all adjustment comes via trade flows.

(c) Burden-Sharing - Table 4 shows how several formulae for allocating deficits might work. However, it should be noted that if a choice among formulae were available, different countries each selecting the formula which minimizes their deficits could result in a set of target deficits totalling on the order of $20 billion, or about one-half the total OECD deficit to be shared out.

The question as to how the total OECD deficit should be shared out is to a considerable degree the long-standing one of reconciliation of structural targets -- i.e., countries' desires to run current account surpluses. In the present situation it is complicated by the problems discussed above, as to (a) whether private market forces will tend to cause financing flows to match the distribution of current account balances, and (b) whether governments' actions will help or hinder this process (the problems of under- and over-borrowing). To some extent these will depend on domestic policy considerations, to which we turn next.

5. National MacroEconomic Policy Problems

The problem of adjusting to the altered balance of payments outlook is compounded by the increasing interdependence of national economies. In a world where stagflation is the order of the day, differing views on the relative priorities of growth and anti-inflation have increased significance. Thus, for example, the U.S. and Germany are running tight monetary policies to fight domestic inflation.

However, their current account balances are such that this will probably result in excessive capital inflows, leaving other countries with the task of either tightening up also or taking action to reduce their current deficits.

Thus countries wishing to expand domestically, or to increase net exports, will be forced to devalue and accept a further deterioration in their terms of trade. Given this problem, increasing pressure has come to bear on the U.S. to expand domestically, so as to accommodate the needs or desires of other countries for increased net exports and thus smaller current account deficits.

B. Specific U.S. Problems

1. Possibility of Excessive Inflows

The U.S. is presently running a tight monetary policy. In addition, the sheer size of the U.S. capital market would lead one to expect *a priori* that it will attract a substantial proportion of total OPEC funds. Barring some mechanism for re-exporting some part of these funds, or a substantial increase in the expected U.S. current account deficit, there could be substantial upward pressure on the dollar.

2. Reversion to Residual Role in World Payments Structure

ticular payments structure and/or inability to finance current account deficits, the result could be a large scale export drive directed at the large, relatively open U.S. market. (There could also be increasingly severe competition for U.S. exports in third markets, especially OPEC markets involving bilateral deals). Again, a general tendency to devaluation vis-a-vis the dollar would be a likely accompanying phenomenon. In addition, intensified use of industrial policies to replace U.S. exports with domestic production could be expected.

3. Return of the Dollar to a Central Role in the System

If (1) and (2) develop, it is quite possible that we could in effect revert to a dollar standard, with other countries in effect adjusting exchange rates and current balances vis-a-vis the U.S. B/P policy would then be constrained in the all-too-familiar fashion, with financing of externally-determined current account deficits the primary concern of balance of payments policy.

<u>If Arabs hold or invest dollars received in any of following ways</u>:

(a) directly in U.S. as identifiable, liquid or other standard-form official reserve holdings;

(b) as loans to or other placements with IMF (or BIS), of any maturity;

(c) as direct Arab loans of any kind to European or other-foreign monetary authorities; or

(d) as Euro-bank deposits or Euro-bond investments (regardless of maturities or Arab-side holders) which result in dollars involved accruing to any European or other official holders

<u>then U.S. balance-of-payments effects will depend on sources from which Europeans raised such dollars</u>, as follows:

	Basic Balance	Net Liquidity Balance	Gross Liquidity Balance	ORT Balance
(1) Use of own directly-held official $ reserves; borrowing officially-held dollars from Arab governments or central banks; drawings on FRB swaps; or drawings from IMF (or BIS)	Neutral	Neutral	Neutral	Neutral
(2) Borrowing from IFI's or other foreign private lenders (incl. Euro-banks & Euro-bond market) of $ already held as direct liquid claims on U.S. by such IFI's, banks or other private foreign holders	Neutral	Neutral	Neutral	HURT
(3) Direct or indirect borrowing from U.S. banks or large corporations in reported-liquid form (i.e. foreign money-market paper and bank deposits incl. Euro-$ deposits)	Neutral	Neutral	HURT	HURT
(4) Borrowing from U.S. private sources either in reported non liquid short-term form (e.g. bank loans) or directly or indirectly) from unreported outflows of U.S. small-investor funds	Neutral	HURT	HURT	HURT
(5) Long-term borrowing from U.S. (e.g. bond issues & bank loans)	HURT	HURT	HURT	HURT

If Arabs hold dollars received either:

(a) as liquid short-term placements (bank deposits, Treasury bills, etc.) in the U.S., held through non-official agents (Arab or other-foreign banks, investment managers, etc.); or

(b) as Euro-$ placements (regardless of maturity or official/private character) which either are retained by Euro-banks or accrue to their non-official non-U.S. customers as additional liquid balances in the U.S.

then U.S. balance-of-payments effects will depend on sources from which Europeans raised such dollars, as follows:

	Basic Balance	Net Liquidity Balance	Gross Liquidity Balance	ORT Balance
(1) Use of own directly-held $ reserves; borrowing officially-held dollars from Arab governments or central banks; drawings on FRB swaps; or drawings from IMF (or BIS)	Neutral	Neutral	Neutral	HELP
(2) Borrowing from IFI's or other foreign private lenders (incl. Euro-banks & Euro-bond market) of $ already held as direct liquid claims on U.S. by such IFI's, banks or other private foreign holders	Neutral	Neutral	Neutral	Neutral
(3) Direct or indirect borrowing from U.S. banks or large corporations in reported-liquid form (i.e. foreign money-market paper and bank deposits incl. Euro-$ deposits)	Neutral	Neutral	HURT	Neutral
(4) Borrowing from U.S. private sources either in reported non liquid short-term form (e.g. bank loans) or (directly or indirectly) from unreported outflows of U.S. small-investor funds	Neutral	HURT	HURT	Neutral
(5) Long-term borrowing from U.S. (e.g. bond issues & bank loans)	HURT	HURT	HURT	Neutral

If dollars received by Arabs are used:

for any kind of investment in U.S. (e.g. real estate) which fails to get reported as a foreign-capital inflow

then U.S. balance-of-payments effects will depend on sources from which Europeans raised such dollars, as follows:

	Basic Balance	Net Liquidity Balance	Gross Liquidity Balance	ORT Balance
(1) Use of own directly-held official $ reserves; borrowing officially-held dollars from Arab governments or central banks; drawings on FRB swaps; or drawings from IMF (or BIS)	Neutral	HELPS	HELPS	HELPS
(2) Borrowing from IFI's or other foreign private lenders (incl. Euro-banks & Euro-bond market) of $ already held as direct liquid claims on U.S. by such IFI's, banks or other private foreign holders	Neutral	HELPS	HELPS	Neutral
(3) Direct or indirect borrowing from U.S. banks or large corporations in reported-liquid form (i.e. foreign money-market paper and bank deposits incl. Euro-$ deposits)	Neutral	HELPS	Neutral	Neutral
(4) Borrowing from U.S. private sources either in reported non liquid short-term form (e.g. bank loans) or (directly or indirectly) from unreported outflows of U.S. small-investor funds	Neutral	Neutral	Neutral	Neutral
(5) Long-term borrowing from U.S. (e.g. bond issues and bank loans)	HURTS	Neutral	Neutral	Neutral

If Arabs use dollars received:

either directly or indirectly, for long-term investments in the U.S. (e.g. portfolio securities, direct investment, or bank CD's) which get reported as foreign inflows and classified as non-official, rather than foreign-monetary, holdings.

then U.S. balance-of-payments effects will depend on sources from which Europeans raised such dollars, as follows:

	Basic Balance	Net Liquidity Balance	Gross Liquidity Balance	ORT Balance
(1) Use of own directly-held $ reserves; borrowing officially-held dollars from Arab governments or central banks; drawings on FRB swaps; or drawings from IMF (or BIS)	HELP	HELP	HELP	HELP
(2) Borrowing from IFI's or other foreign private lenders (incl. Euro-banks & Euro-bond market) of $ already held as direct liquid claims on U.S. by such IFI's, banks or other private foreign holders	HELP	HELP	HELP	Neutral
(3) Direct or indirect borrowing from U.S. banks or large corporations in reported-liquid form (i.e. foreign money-market paper and bank deposits incl. Euro-$ deposits)	HELP	HELP	Neutral	Neutral
(4) Borrowing from U.S. private sources either in reported non liquid short-term form (e.g. bank loans) or (directly or indirectly) from unreported outflows of U.S. small-investor funds	HELP	Neutral	Neutral	Neutral
(5) Long-term borrowing from U.S. (e.g. bond issues & bank loans)	Neutral	Neutral	Neutral	Neutral

TABLE 1

Selected OPEC Country Data for 1972 and 1974
(preliminary est.); billions of dollars

Country	Oil Revenues		Foreign Reserves		Current Account	
	1972	1974 (est)	1972	1974 (est)	1972	1974 (es
Saudi Arabia	3.1	23-28	2.5	20-25	1.4	20-22
Kuwait	1.7	7-9	2.5e	8-10	2.0 1/	5-6
Libya	1.6	6-8	2.9	6-8	.9	4-6
Iraq	.6	6-7	.8	6-8	.2	3-4
United Arab Emirates	.5	4-6	N/A	4-5	N/A	3-4
Algeria	.7	3-4	.5	1-2	-.1	0-.5
Qatar	.2	1-2	N/A	1-2	N/A	1-2
Iran	2.4	18-21	1.0	9-11	-.4	8-10
Venezuela	1.9	9-10	1.7	6-8	-.1	4-6
Nigeria	1.2	7-9	.4	5-7	-.5	5-6
Indonesia	.7	3-4	.6	1-2	-.4 2/	0-1
OPEC TOTAL	14.6	95-105	N/A	80-90	N/A	55-65

1/ Trade balance.
2/ 1971 figure.
e indicates estimate.
N/A indicates not available.

NOTE: Columns will not add to totals due to rounding.

TABLE 2

OECD Current Account Forecasts
Pre- and Post- Oil Crisis
($ billion)

	A. Pre-Oil Situation	B. Post-Oil Projection Absent Major Adjustment Action	
	Column A1 1974 Calendar Year Pre-Crisis Projections OECD Sept. 1973 (Approx. Equilibrium Current Account Structure)	Column B1 Calendar Year 1974 OECD Projections (adjusted) *	Column B2 Fiscal Year 1975 OECD Projections
.S.	5.0	- 3.0	- 4.50
anada	- 0.7	- .7	- 1.65
apan	0.3	- 7.5	- 6.25
ermany	1.8	+ 5.5	2.75
rance	0.6	- 6.5	- 5.90
taly	1.0	- 7.5	- 6.50
.K.	- 1.8	-10.5	- 9.15
Major 7	+ 6.2	-30.2	-31.30
ther OECD	+ 3.8	- 9.8	-10.30
otal OECD	+10.0	-40.0	-41.50
est of World	-15.0	-15.0	-23.50
PEC	+ 5.0	-55.0	-65.00

* U.S. adjusted for $2 billion rupee grant to India

Table 3

C. Some Possible Decentralized Adjustment Scenarios
1975 Final Figures ($ billions)

	Column C1: Japan and France Meet Announced Targets (combined improvements of approximately $6 billion during fiscal 1975)*		Column C2: All Countries Other Than the U.S. Cut Current Deficit in Half
	(a) Their Improvements Shared Among All Countries	(b) Their improvements Shared Among OECD Countries	
U.S.	-5.91	-6.91	-37.02
Canada	-1.90	-2.07	-.83
Japan	-1.75	-1.75	-3.13
Germany	2.29	2.10	2.75
France	-4.55	-4.55	-2.95
Italy	-6.70	-6.77	-3.25
U.K.	-9.37	-9.50	-4.58
Major 7	-27.89	-29.45	-49.01
Other OECD	-11.44	-12.05	-4.28
Total OECD	-39.33	-41.50	-53.29
Rest of World	-25.67	-23.50	-11.75

*Japan eliminates current account deficit at end of 1975. France reduces deficit to $3 billion by end of 1975, giving $4.5 billion deficit for fiscal year 1975.

TABLE 4

Deficits Implied by Various Sharing Schemes
1974 Calendar Year

D. Adjustments applied to pro rata shared initial aggregate current account surplus of the OECD countries

	Status Quo	1972 World Trade Share	1972 World GDP Share	1973 World Oil Import Share
United States	- 3.000	- 6.892	-17.860	- 8.920
Canada	- .700	- 2.916	- 1.608	- 1.440
Japan	- 7.500	- 3.972	- 4.464	- 7.768
Germany	+ 5.500	- 6.480	- 3.904	- 3.236
France	- 6.500	- 3.636	- 2.972	- 4.000
United Kingdom	-10.500	- 3.380	- 2.336	- 3.352
Italy	- 7.500	- 2.572	- 1.784	- 3.512
Subtotal	-30.200	-29.848	-34.928	-32.228
Other OECD	- 9.800	-10.152	- 5.072	- 7.772
Subtotal	-40.000	-40.000	-40.000	-40.000
Rest of World	-15.000	-15.000	-15.000	-15.000
TOTAL	-55.000	-55.000	-55.000	-55.000

* World is defined as those OECD nations whose 1972 GDP figures were available in the May 1974 OECD Main Economic Indicators i.e., most OECD nations.

Oil - Monetary

End 1974

The Effect of OPEC Money on Short-Term Interest Rates in the U.S.

The large increase in OPEC's dollar holdings during the past half year combined with their strong preference for U.S. Treasury Bills are factors which might have reduced the U.S. Treasury Bill rate as well as increased the differential between the CD rate and the Bill rate. On the basis of evidence currently available, OPEC purchases of U.S. Treasury Bills do not appear to have had any systematic effect on Bill yields or on the differential yield between Bills and CD's. This finding is not surprising, since there are so many other factors which may be affecting the level and risk structure of short-term interest rates in the U.S.

Evidence on the effect of OPEC purchases of U.S. Treasury Bills is revealed in the attached three charts. The top two panels of all three charts show -- on a weekly basis for the past six months -- the three-month Treasury Bill rate, the 60-89 CD rate, and the differential between these two rates. In Chart 1, the bottom panel shows the end-of-month holdings of Treasury Bills by foreign official institutions -- both all holdings and those of OPEC. OPEC holdings have more than tripled during the past half year. Nevertheless, their holdings are still a small fraction (less than 15 percent) of those of all foreign official institutions. Furthermore, changes in OPEC holdings are at times swamped by changes in other foreign official institutions' holdings, as is illustrated by the August figures.

Weekly data on OPEC holdings of Treasury Bills are not available. Weekly data, however, on variables directly related to OPEC's holdings of Treasury Bills are presented in the bottom panels of Charts 2 and 3.

In Chart 2, the bottom panel shows the U.S. Treasury securities held for OPEC by the Foreign Department of the Federal Reserve Bank of New York. This series, which includes some holdings of long-term Governments as well as short-term ones, starts on September 6. (The Federal Reserve Bank of New York may be able to supply the information necessary to begin this series in May so as to give a better correlation with the data on short-term U.S. interest rates).

In Chart 3, the bottom panel shows the changes in liabilities of the U.S. to all official foreigners. Data in Charts 2 and 3 support the evidence in Chart 1 revealing no systematic effect of OPEC Treasury Bill holdings on short-term interest rates in the U.S.

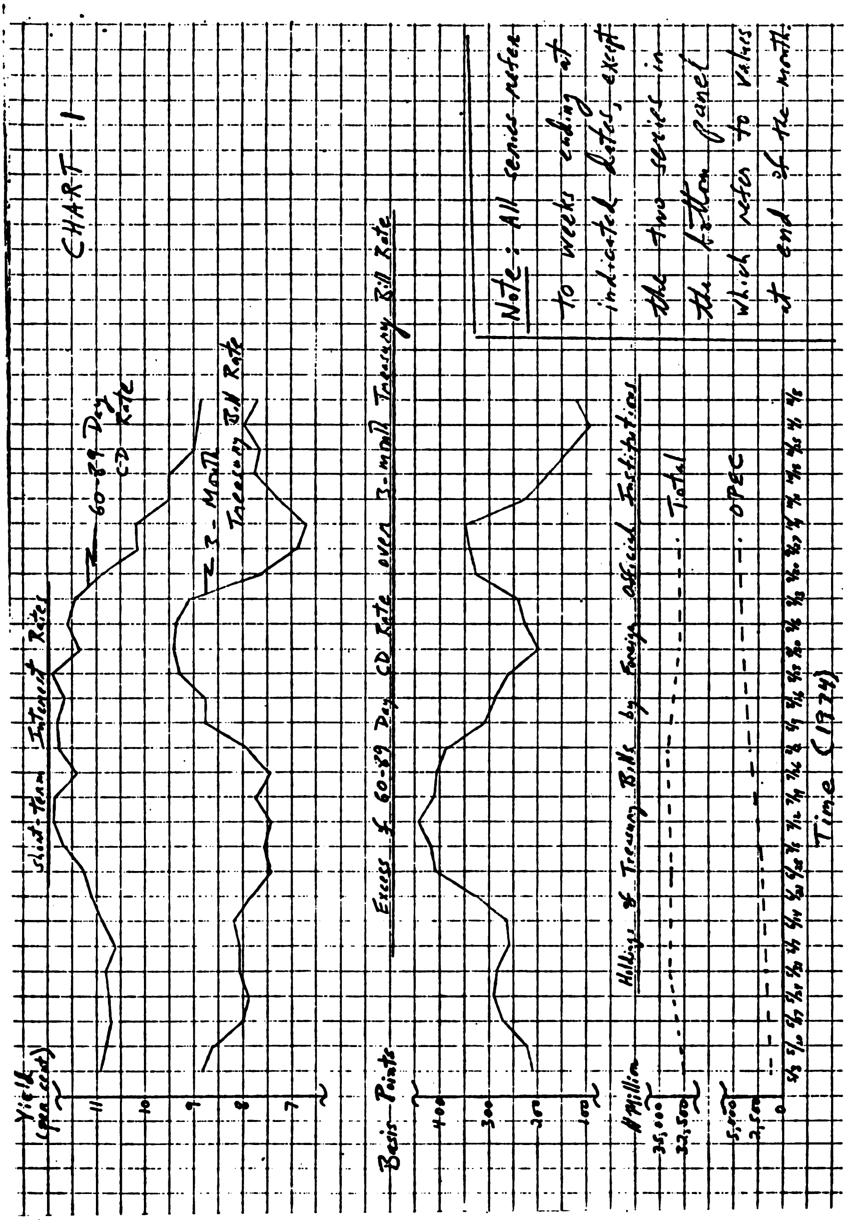


CHART 1
Short-Term Interest Rates
Yield (per cent)
11
10
9
8
7
60-89 Day CD Rate
3-Month Treasury Bill Rate
Excess of 60-89 Day CD Rate over 3-Month Treasury Bill Rate
Basis Points
400
300
200
100
Holdings of Treasury Bills by Foreign Official Institutions
$ Million
35,000
32,500
5,000
2,500
0
Total
OPEC
Time (1974)
Note: All series refer to weeks ending at indicated dates, except the two series in the bottom panel which refer to values at end of the month.

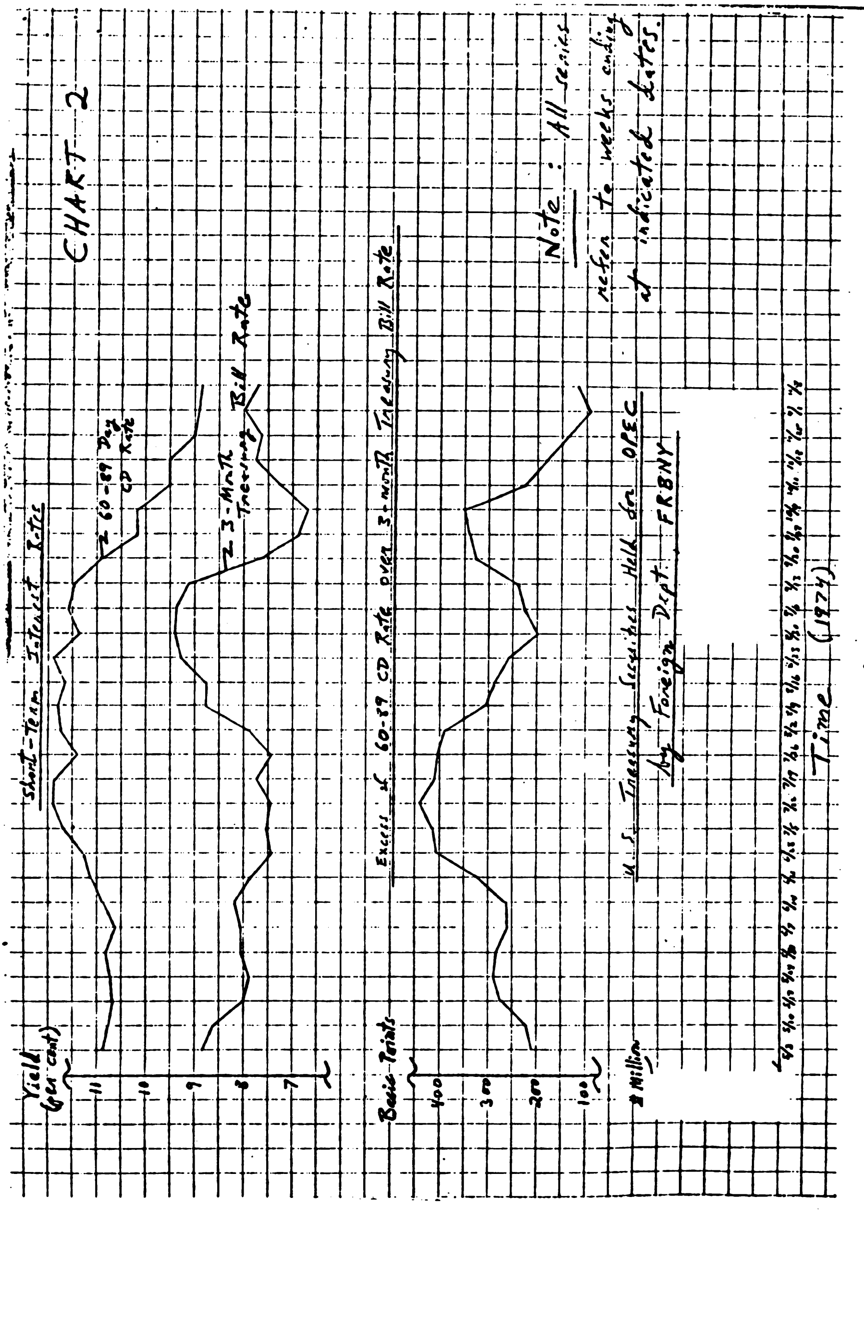


CHART 2
Short-Term Interest Rate
Yield (per cent)
11
10
9
8
7
60-89 Day CD Rate
3-Month Treasury Bill Rate
Excess of 60-89 CD Rate over 3-month Treasury Bill Rate
Basis Points
400
300
200
100
U.S. Treasury Securities Held for OPEC by Foreign Dept. FRBNY
$ Million
Time (1974)
Note: All series refer to weeks ending at indicated dates.

OPTIONAL FORM NO. 10
MAY 1962 EDITION
GSA FPMR (41 CFR) 101-11.6
UNITED STATES GOVERNMENT

Memorandum

Department of the Treasury
Washington, D.C. 20220

DRAFT

TO : Deputy Assistant Secretary Willett

DATE: December 18, 1974

FROM : David J. Klock JK

SUBJECT: R. Cooper Recycling Proposals

Cooper has a three-pronged approach to the problem.

The first is short-run, and aimed at removing constraints to private "reshuffling". His major concerns appear to be that a combination of (1) fears that large OPEC deposits will be shifted among banks, and (2) that banks' lending and borrowing activities are constrained by statutory or conventional limits on exposure to individual depositors and ratios of loans to capital, will lead to a drying-up of private recycling channels within the next few months. In this context, he argues that the large banks which have received the bulk of the OPEC deposits have begun to "resist new petrodollar deposits." However, the latest OASIA review of OPEC accumulation notes that "International credit markets generally have revived in September and October, with a growth in the size of the Euro-dollar market, increased foreign bond issues and a slowdown in the contraction of U.S. bank lending."

5010-108

To avoid such a possible seizing-up of the private recycling mechanism, Cooper argues for a well-publicized central bank agreement to stand ready to -- "rediscount, on a large scale, loans made by commercial banks to governments in the event large deposits of petrodollars are withdrawn from these banks."

-- "relax any regulations or conventions governing the acceptable ratio of loans to bank capital..."

-- "undertake close surveillance of the short- and medium-term money markets, especially on the lending side..."

The latter two proposals seem quite reasonable, although there might be limits to how much increase in the ratio of loans to capital would be desirable. The large-scale rediscount facility poses more problems.

(1) Should only loans to countries be rediscountable?

(2) If access to the discount window is automatic, does this remove or reduce desirable pressure on borrowers to conserve oil and generally put their economic houses in order? If it's not automatic, who gets squeezed? The bank, the borrower(s), the lenders?

(3) Does this reduce desirable pressure on OPEC to diversify and/or accept its share of the risk?

(4) Does it enhance the possibility of OPEC countries shifting funds around from bank to bank in capricious fashion?

On balance, it probably would be better to stick to the general assurance that banks will not be allowed to go under for reasons beyond their control (though this should probably be somewhat less delphic than the pronouncements to date on this matter) coupled with some relaxation of the guidelines, conventions, rules of thumb, etc. which may represent a constraint on private recycling.

Cooper's second, longer-term (5 to 10 years) proposal is for a new international institution to borrow OPEC funds at "competitive rates and varying maturities, and lend to oil-consuming countries at non-concessional rates and for varying maturities." By contrast to Healey et. al., this has several advantages -- for example, it would operate outside the Fund, with the possibility of lending to different countries at different terms (at least as regards maturities). The extent to which such a facility -- no size is suggested -- might supplant or supplement private markets is not discussed, though one advantage cited is that it might make OPEC less leary of having funds placed in countries with histories of "blocking" foreign assets. As other advantages he cites: reduced motivation for oil producers to cut production, closer involvement of OPEC in recycling, and sharing of risk with OPEC. How this last would be accomplished is not indicated specifically in the paper.

Cooper appears to see OPEC as a partner in the operation of the institution, since the paper notes that such an institution "would involve granting considerable decision-making power to OPEC." (Cooper apparently thinks this is inevitable anyway.)

The third of Cooper's proposals is for aid to MSA's through a combination of direct aid by OPEC (possibly by a lower price for oil) and a special facility in either IMF or IBRD, which would borrow on world markets to re-lend at concessional terms. The interest subsidy could be financed by IMF gold sales.

APPENDIX 9.—PROPOSALS FOR CONTROLLING OR DIRECTING THE FLOWS OF OPEC SURPLUSES AND INVESTMENTS, INCLUDING U.S. GOVERNMENT POLICY OPTIONS

• Integration of Key OPEC States Into the Decision-Making Structure of the International Financial System

File: OPEC F 16 NS #16

The question has been raised as to how the U.S. might facilitate the process of integration of key OPEC nations into the decision-making structure of the international financial system. In looking at this question, two points must be made initially:

(1) that the question of OPEC "integration," or greater participation, is a question that must initially and <u>primarily</u> be dealt with by the OPEC states themselves;

(2) that the U.S. must be very deliberate in formulating a broad approach to this issue, taking into account all relevant considerations, political as well as economic, to ensure that any action taken by the U.S. is consistent with our national interests.

As a direct result of the oil price increases of 1973 and 1974, the OPEC countries necessarily have become more integrated into the international financial system. Their unprecedented balance of payments surpluses, which amounted to roughly $150 billion during the years 1974 to 1976, have been largely invested in the capital markets of the industrial nations, and have been recycled through these markets to the world's deficit countries. During this period, the OPEC nations have not demonstrated substantial interest in assuming greater integration into the international financial system -- they have, in fact, been reluctant to become central actors in the overall management of the system, with the heavy responsibilities entailed by such a role. Their primary economic concern appears to have been safeguarding the value of their assets and protecting their investments from confiscation, blockage, or other arbitrary measures. Their interests in participating in the management of the system have focused on building regional institutions that they can control. OPEC's reluctance to accede to a position of importance and power in international financial decision-making circles may also reflect political concerns of both a regional as well as international nature. They are hesitant to become aligned with the industrial nations because of the risks of alienating the developing nations and thereby increasing the attacks on OPEC pricing policies.

The main avenues for integration of key OPEC states into the decision-making structure of the international financial system are through existing multilateral institutions. OPEC interest and willingness to become more involved are, of course, prerequisites to any changes in their roles in multilateral institutions. Assuming that they are interested -- and that it is in our national interests to promote greater involvement by OPEC members -- the question of how this could be facilitated is very complex. Six OPEC members have recently made commitments, along with seven industrial countries, to provide additional resources to the IMF on a temporary basis under the Supplementary Financing Facility.

The U.S. encouraged such participation -- it not only greatly increases the resources available to the IMF under the facility, but demonstrates the willingness of the OPEC countries to share with the industrial countries responsibility for a strong and smoothly operating international monetary system.

Other specific questions of increased OPEC integration are much more complex and difficult to assess. The question of a possible seat for Saudi Arabia on the IMF's Executive Board, for example, has recently arisen. If it is determined late next summer that Saudi Arabia has the right to appoint a Director, it will ~~like the more general question of OPEC integration~~ be a matter for Saudi Arabia to decide.

CLASSIFIED BY Donald E. Syvrud
SUBJECT TO GENERAL DECLASSIFICATION
SCHEDULE OF EXECUTIVE ORDER 11652
AUTOMATICALLY DOWNGRADED AT TWO
YEAR INTERVALS AND DECLASSIFIED
ON DEC. 31 1983

DECLASSIFIED
AUTHORITY: E.O. 12065 [illegible]
DATE: 9/10/79

February 18, 1975

Options for U.S. Policy
On Foreign Investment in the United States

After an extensive review of U.S. laws and regulations relating to business activities and foreign investment, and bearing in mind the econmic and political implications of large OPEC surpluses, four options, which are discussed below, have been developed to facilitate consideration of future U.S. policy with respect to such investment. The proposed options distinguish between official and private foreign investment and between choices that may be adopted by the Executive Branch or require legislation. The first three options are presented in an order representing increasing U.S. Government intervention. The fourth option represents a more specific limitation, but it applies to official foreign investment only.

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AUTHORITY: J. C. Griffin
DATE: 3/24/78

Option 1 - Maintain existing policy and improve implementation by executive action, including the handling of problems of foreign government investment on a bilateral government-to-government basis.

This option would maintain our traditional open door policy and rely on existing restrictions and controls to regulate foreign investment in the United States. It would, however, improve implementation of our current policy by (1) making administrative changes to expand our existing data gathering and dissemination capability; (2) enforcing more rigorously existing laws and regulations to control the entry and activities of foreign investors; and (3) creating a new office within the Executive Branch to serve as a focal point for government activity with respect to foreign investment in the United States.

Within current authority the Administration could also deal with official foreign investment on a bilateral government-to-government basis, making use of the Joint Commissions whenever possible. The details could vary depending on the country, but the essence would be for the investing government to define its investment goals and for us to note areas where investment is legally permitted and indicate kinds of activity that would cause us problems. The arrangement might take the form of an agreement between the U.S. Government and the investing government.

Advantages

-- Utilizes powers the Administration has under existing laws and does not require action by Congress, which might overreact and add unnecessary restrictions on foreign investment.

-- Requires substantial current information (including identity of beneficial owner) on all significant foreign investment in publicly-traded companies U.S. companies with more than $1 million assets and more than 500 shareholders.

-- Can be put into effect immediately whenever the President decides action is necessary.

-- Adoption would give the Administration further time to evaluate the need for more drastic action.

-- Consistent with our desire to create a free and open economy and avoids new restrictions which could invite retaliation, violate FCN treaties and undercut our efforts in the OECD to encourage more liberal investment policies.

-- Treats substantial foreign government investment as a political/foreign policy matter particularly suitable for government-to government negotiations.

-- Enables USG to give informal guidance, which is a type of screening of foreign investment.

-- Minimizes the likelihood of possibly contentious investment.

-- Provides umbrella for foreign government investment in the U.S.

-- Provides advance notice of foreign investment and time by using existing legal and foreign policy tools.

Disadvantages

-- Existing confidentiality requirements would limit disclosure of information on individual investors in areas not covered by SEC.

-- Congress may not be satisfied with a system which only requires disclosure of the beneficial owners of publicly traded companies.

-- May not preclude Congressional action to enact new restrictions and/or reporting requirements.

-- Bilateral arrangements between the U.S. and investing governments may foster bilateralism.

-- Bilateral arrangements would involve the U.S. Government in the investment process which might make us subject to charges of arbitrarily favoring certain types of investments.

-- Consultation between the U.S. and the investing governments may not adequately protect against unwanted foreign investment.

-- Existing laws and residual powers to control foreign investment may not be adequate to deal with foreign government investment which may be motivated by political objectives.

Discussion

Adoption of this option is based on the assumption that our existing powers and recourse to bilateral consultations are adequate for the present to provide sufficient information on, and control of, foreign investment in the United States.

The administrative changes in existing programs might include action by the SEC to (1) require specific identification on its report forms of the nationality of all foreign beneficial owners; (2) compile and publish a list of foreign beneficial owners; and (3) express its intention to impose all available sanctions (including the loss of voting rights) on persons who violate its regulations. Commerce Department (BEA) regulations require reports to be filed with respect to every business enterprise in the United States when foreign participation exceeds $2 million and foreigners own an interest that exceeds 10 percent in such enterprise. However, confidentiality requirements prevent disclosure of any information re individual investors. Administrative changes could be made to lower the percentage holding to 5 percent and the $2 million exemption to a smaller figure.

Our general laws to ensure against abuse of economic power and a series of laws dealing specifically with foreign investment give us substantial existing power to prevent foreign investors from acting contrary to our national interest. This option would see that these laws were rigorously enforced by centralizing watchdog responsibility with respect to violations of existing laws in a newly created office which would report periodically on the adequacy of existing protections and controls.

Other functions of the new office would be to obtain (to the extent permitted by existing confidentiality requirements) data on foreign investment from all departments and agencies actually collecting data; to explore the extent to which these confidentiality requirements could be relaxed; and to prepare and publish periodic reports on foreign investment. The new office could be created by Executive Order, accompanied by a statement from the President or high Administration official outlining in detail the extent of our existing authority and information.

By centralizing information and publishing periodic reports on foreign investment, we could provide adequate information on significant non-government investment even though there might be minor gaps as noted above. In addition, existing laws give us broad power to prevent misuse of foreign investment motivated by purely economic considerations. Whether this is also adequate to handle OPEC government investment depends on an assessment of the amount, timing and direction of such investment flows and on whether OPEC governments will be governed by political or economic motives. The provision in this option for government-to-government consultations (that is, in addition to the consultations already being carried on) recognizes that different OPEC investors will have different investment objectives and needs and provides a flexible means of tailoring our policy response to those needs.

Option 2 - Seek new legislation to improve reporting requirements and strengthen existing powers to prevent abuses.

Definition of Option. Under this option, the Administration would ask Congress for legislative authority to remedy the weaknesses in our existing reporting and disclosure requirements for foreign investors. These improvements could be effected by building on an existing set of requirements, for example those administered by the SEC, or by establishing a new reporting system and a bureaucracy to administer it. They would be designed to enable us to obtain more complete information as to the identity of foreign investors in firms whose stock is publicly traded, as well as additional information on transactions involving real estate and non-public companies.

The Administration might also seek legislation to improve our existing powers to prevent foreign private and/or government investors operating in our economy from acting in a way contrary to our national interest. It would not touch on entry of foreign investment -- which would continue to be governed by existing laws -- but would concentrate on use of the investment once the foreign investor was established here. The improvement in our powers to control, and to remedy abuses caused by, existing investment could be provided by (1) plugging gaps in and/or expanding the President's existing emergency powers -- under the Defense Production, the Selective Service, and the Trading with the Enemy Acts -- and/or (2) plugging gaps in existing general laws affecting foreign investment.

Advantages

-- Meets Congressional concerns about the adequacy of our information gathering capabilities.

-- Adoption would give the Administration further time and better information to evaluate the need for more drastic action.

-- Allows a free flow of investment into the U.S. but improves our existing power to prevent action contrary to our national interest.

-- Utilizes powers the U.S. has under existing laws to regulate entry of foreign investment.

-- Concentrates the remedy on the problem of possible misuse of foreign investment.

-- Consistent with our desire to create a free and open economy and avoids new restrictions which could invite retaliation, violate our FCN treaties, and undercut our efforts in the OECD to encourage other countries to adopt more liberal investment policies.

-- Would expand existing authority to deal with extreme abuses after the fact.

Disadvantages

-- Does not meet concerns about deficiencies in existing powers to deal with misuse of assets by a foreign investor and does not provide protection against "pervasive foreign influence."

-- Requires Congressional action and may serve as magnet for more restrictive legislation and/or focus unwanted Congressional attention on the President's emergency powers -- which are already under attack in Congress.

-- Creating a general reserve or residual power in the President would, without precise standards or guidelines for its use, create great uncertainty for a foreign investor and might discourage foreign investment in the U.S.

-- Any expanded (or new) powers would be primarily remedial and would not prevent all abuses of foreign investment in the U.S.

-- There are substantial doubts (which need to be resolved) as to whether the President could be given such general powers to undo, resolve, or mitigate an individual investment (as opposed to a class or category of transactions) once it had been established here.

This option is concerned with improvements in our data-gathering and disclosure capabilities, as well as our capability to deal with abuses by foreign investors, including our powers to correct extreme abuses after they occur. The changes would be achieved by legislative action. Adoption of the option would still allow investment to flow freely into the United States in accordance with existing laws, on the assumption that there is no clear way in all instances of identifying unwanted foreign investment until the activities of the investor are evaluated. (A number of U.S. laws already prevent or limit foreign investment in various industries.)

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The legislative changes would be designed to remedy the weaknesses in our existing reporting and disclosure requirements with respect to foreign investment that could not be adequately dealt with by administrative action. A major weakness of our existing requirements relates to the identification of "beneficial owners" or the equity of U.S. firms. This problem could be easily solved if all that was involved in this type of case was use of a domestic nominee by a foreign investor. In fact the SEC has recently held hearings on this issue and may soon be proposing changes in its practice or legislative authority to enable it to deal with the nominee question. However, a simple disclosure requirement would not be sufficient in a case where a foreign investor used a foreign nominee (or series of them) to conceal his identity. Penetration of these nominee "veils" would in many instances prove impossible because of problems of legal jurisdiction and of protections embodied in the commercial and bank secrecy laws of other countries. It should, however, be noted that a foreign investor hiding behind nominee "veils" who voted his shares or otherwise acted in a way contrary to the interest of the firm or the United States would probably expose himself by his action.

A possible solution to the nominee problem would be to ask Congress to authorize a strong disclosure requirement backed up by an effective penalty for non-compliance. One such penalty that has been suggested is suspension of the voting rights of the stock in question, but other possible formulas might be identified and explored. Responsibility for implementation of the new requirements could be given either to an existing agency or to one created especially for this purpose.

With regard to improving our powers to prevent or to correct major abuses, we would concentrate on weaknesses in the Defense Production Act, the Selective Service Act, and the Trading With the Enemy Act.

The Department of Defense has reservation as to the extent of the President's powers under the Defense Production and the Selective Service Acts to ensure the availability of productive capacity for Defense purposes. For example, there are doubts as to (1) the extent of the President's powers under these acts to prevent plant closure or to require continuation of defense related business, and (2) application of the Selective Service Act in a non-war situation. In addition, the Trading With the Enemy Act is under increasing criticism in Congress, and new legislation might be necessary to ensure its continued application in a non-emergency situation. Moreover, there are doubts as to whether the President could (or would want to) apply the Trading With the Enemy Act after the fact to undo, or mitigate abuses by indivual foreign investors on an _ad hoc_ case-by-case basis without precise standards. Therefore, any consideration of broad new emergency powers to deal with foreign investment after it had entered would need a careful review of the legality and desirability of giving the President broad powers to control (e.g. seize or divest) individual firms on an _ad hoc_ basis.

Adoption of the option would not give absolute assurance that it would prevent all possible abuses by foreign investors. On the other hand, there are numerous and possibly more effective measures outside the field of investment (for example, selective letting of contracts or placing of purchase orders, or selective placement of funds) that a foreigner could employ to influence a U.S. firm to act in a desired way.

Option 3 - Impose Screening Procedures on Inward Foreign Investment Under New Legislation

Definition of Option - This option calls for the establishment of a mandatory screening procedure, to be applicable to new direct investment as well as foreign acquisitions and mergers with U.S. firms. Its application to certain investments would be prohibited by existing FCN treaties. It would be supplemental to our existing measures affecting foreign investment.

The screening procedure could be established in either of three ways. Suboption A is a discussion of a screening procedure applicable to all foreign investors in industries that are considered "key" to the U.S. national interest. Suboption B is discussion of a screening procedure applicable to official foreign investment in all sectors of the U.S. economy. Suboption C is a discussion of a screening procedure applicable only to official foreign investment in key industries.

The suboptions have several elements in common. The criteria for the screening process should be published to avoid confusion on the part of foreign investors and U.S. firms. Each suboption would require prior notification of a central authority which would be responsible for ascertaining, in accordance with internal U.S. Government procedures to be developed, whether there was any objection to the transaction.

If this option should be adopted, it would be desirable to invoke currently available authority to prevent foreign investors from rushing into the U.S. market ahead of the enactment of legislation. Such authority is found in Section 5(b) of the Trading With the Enemy Act as amended; a legal statement on the Act is the second appendix to this paper.

Screening of certain investments would conflict with some Treaties of Friendship, Commerce and Navigation. Accordingly, further study would be necessary to determine how potential treaty conflicts might best be handled, for example, by prior consultation aimed at avoiding a treaty conflict, by renegotiation of relevant treaties, or by having the screening legislation exempt treaty countries from the screening process. The first Appendix to this paper contains a discussion of the FCN Treaty issue. It should be noted that the problem of a treaty conflict arises, in the case of screening initial investments, only with a few countries (many of which are OECD members and none are OPEC members) from which official foreign investment is limited. Moreover, all FCN treaties permit screening of investments in certain sensitive areas.

Suboption A - Screen foreign investment in industries that are key to the national interest.

Definition of Suboption A. This proposal requires a prior determination that certain industries are key to the national interest and that all foreign investment in these industries should be screened, before the investment is consummated.

Advantages

-- Deals directly with the concern that foreign investors might gain an unacceptable degree of influence in key industries.

-- Provides an opportunity for the U.S. Government to prohibit any foreign investment in key industries or to allow it to proceed subject to whatever conditions the Government might decide to apply.

-- Might remove some uncertainty regarding U.S. policy on foreign investment.

-- Reduces possibility that Congress might impose unacceptable restrictions.

-- Nondiscriminatory between investors.

Disadvantages

-- Definition of key industries is inherently difficult or arbitrary.

-- Administration would be continuously subjected to pressure from foreign investors, U.S. firms, or interested third parties to make decisions on grounds not related to national interest.

-- Congress may pass more restrictive legislation anyway; particularly Congress may add to the list of proscribed sectors.

-- Complex, cumbersome and expensive to administer.

-- Places affected firms at a disadvantage in raising capital.

-- Risk that U.S. Government might block or restrict transaction would prejudice seller's bargaining position.

-- Marked departure from our longstanding commitment to creation of a free and open world economy and our efforts to achieve international investment reform.

-- Screening could deter some desirable foreign investment.

-- May be in conflict with FCN treaty obligations.

Discussion

A significant difficulty with Suboption A is the problem of defining an industry or company that is key to our national interest. Any definition is subject to criticism. For example, any company that requires a security clearance to work on a U.S. Government contract could be considered key; this definition would, however, apply to some 12,000 U.S. firms. One might also screen foreign investment in U.S. firms that do not use advanced technology and do not produce defense-related goods but are critical to national survival. Examples include (by no means exhaustively) the steel industry, food and foodstuff processing, and vehicles and parts. Factors that would have to be taken into account in developing a screening procedure for foreign investment in key industries are given in the annex to this option. Any lists of key industries would generate pressure for additions which would be reflected in the Congress.

Suboption B - Screen official foreign investments in U.S. industries.

Definition of Suboption B. This proposal focuses on the type of foreign investor rather than on the U.S. concern and applies a screening procedure to official foreign investment. Private foreign investment would continue freely to enter the United States subject to the prohibitions and restrictions of current U.S. laws and regulations.

Advantages

-- Deals directly with the concern that foreign governments might make unwanted investments in U.S. firms.

-- Provides an opportunity for the U.S. Government to prohibit any official foreign investment or to allow it to proceed subject to whatever conditions this Government might decide to apply.

-- Removes uncertainty regarding U.S. policy on private foreign investment.

-- Avoids need to specify in advance industries in which foreigners may not invest.

-- Reduces possibility of Congressional action and risk that unacceptable restrictions might be imposed.

Disadvantages

-- Creates uncertainty for official foreign investors.

-- Might discourage official foreign investment

-- Would be regarded by OPEC countries as specifically directed against them.

-- Might lead to charges of discrimination between various official foreign investors. including charges of FCN treaty violations.

-- Difficult to define an official foreign investor.

-- Administration would be continuously subject to pressure from official foreign investors, U.S. firms, and interested third parties.

-- Complex, cumbersome, and expensive to administer

-- Risk that U.S. Government would block or restrict transaction would prejudice seller's bargaining position.

Discussion

A critical element in Suboption B is the definition of official foreign investment. A test of the functions of the investor may be inadequate, as in many foreign countries enterprises that would be regarded in the United States as in the private sector are government corporations or government-controlled corporations. Moreover, some monarchies have immense wealth for foreign investment and follow motivations sufficiently different from a private investor so as to be regarded as official investors; this is particularly true with respect to OPEC countries in the Middle East.

The term "government corporation" or "government-controlled corporation" covers several obvious categories of organizations and enterprises (central government departments, central monetary authorities and central banks). Government-controlled corporations that engage in commercial activities (for example, foreign airlines and some industry) present a special problem of definition. Also, a gray area arises in the case of government-private joint ventures, with either private foreign or U.S. citizens. Moreover, while it might be obvious that the screening procedure should be applied to investment by monarchs, it is less clear to what degree of kinship the procedure should be applied. In light of the extended family relationships in some countries, it might be necessary to look to laws and traditions of the country from whence the foreign investor comes.

Identifying official foreign investors could be made difficult by the use of intermediaries in the United States or abroad.

Suboption C - Screen official foreign investment in key U.S. industries.

Definition of Suboption C. This suboption gets down to the central issue of insulating key U.S. industries from manipulation by those foreign investors who might be most likely to be motivated by political rather than economic considerations. It would not apply to all private foreign investment or to official foreign investment in nonessential industries,

Advantages

-- Deals directly with the concern over the potential for unacceptable control by official foreign investors over key U.S. industries.

-- Introduces no new restrictions on private foreign investment.

-- Does not overtly discriminate against OPEC countries.

-- Might remove some uncertainty regarding U.S. policy or foreign investment.

-- Nondiscriminatory between foreign countries.

<u>Disadvantages</u>

-- If applied to all countries, apparently conflicts with a number of FCN treaties (i.e., provision on national treatment for establishment and acquisition). If applied only in absence of such FCN treaty provisions, then issue of OPEC unhappiness over policy aimed almost entirely at them is intensified. (We have no such FCN treaty provision with any OPEC country.)

-- Will be viewed by OPEC countries as aimed specifically at them in attempt to control their investment options, which could lead to some reductions in oil production.

-- Does not cover land sales, <u>per se</u>, which, while difficult to deal with in view of predominate role of State and local governments in land use questions, is a politically sensitive issue.

-- Definition of key industries is inherently difficult or arbitrary.

-- Administration would be continuously subjected to pressure from foreign investors, U.S. firms, or interested third parties to make decisions on grounds not related to national interest.

-- Congress may pass more restrictive legislation anyway; particularly Congress may add to the list of proscribed sectors.

-- Complex, cumbersome and expensive to administer.

-- Places affected firms at a disadvantage in raising capital.

-- Risk that U.S. Government might block or restrict transaction would prejudice seller's bargaining position.

-- Screening could deter some desirable foreign investment.

ANNEX to OPTION 3

Screening of Foreign Investment in Key Industries

I. Introduction

The purpose of this annex is to illustrate how a screening procedure might be structured and to present an example of a possible set of screening criteria. There are numerous possible variations of any such procedure and the following factors are for the most part the minimum measures which would have to be adopted. If the Administration were to choose the screening option, then considerable further effort in developing the procedures and criteria would be necessary.

II. Scope

Screening would supplement current laws, regulations and administrative procedures which already limit (de jure and de facto) foreign investment in certain industries. As it would not be feasible or desirable to screen all foreign acquisitions of U.S. securities, threshold levels should be established, above which screening would be required. In the case of equities, screening could be required when the participation in the ownership by a foreigner, or foreigners deemed to be acting in concert, exceeded, say, 10 percent of the outstanding voting shares of the firm.

It might also be desirable to consider whether a percentage level should be established at which screening would be required of additional equity purchases by unrelated foreigners.

Foreign loans to U.S. firms would also be subjected to screening whenever any loan exceeded, say, 15 percent of the total long-term outstanding debt of the corporation. Transactions below a floor of, say, $1 million would be exempt from screening.

Screening would apply at entry, and the United States would rely on existing laws to regulate firms after entry. Existing foreign investments would be grandfathered. However, the possibility that foreign-owned U.S. firms, after entry, might make investments in firms in sensitive industries, which would have been covered by the screening procedure, gives rise to the risk that this safeguard against undesirable foreign investment could be circumvented. This loophole could be closed only by subjecting secondary investment by foreign-owned firms unrelated to the primary investment to the same criteria that would apply to the initial investment.

Application of screening to secondary investment, however, would be in conflict with our FCN treaties with a number of important countries, including, among the OPEC countries, Iran and possibly Saudi Arabia.

Screening might apply to investments in such industries as defense, transportation, communications, news media and energy. With regard to defense considerations, one possible approach would be to consider as a defense industry any firm that holds a security clearance to sell goods or services to a U.S. Government agency.

III. Screening Procedure

1. The foreign investor, the U.S. firm being acquired and any other parties to the transaction would all have to notify the Federal screening office of the intended investment. Penalties to force compliance should be imposed.

2. The U.S. Government would have 30 days in which to consider the proposed transaction. If, at the end of 30 days, the parties to the transaction had not been advised to the contrary by the screening office, they would be free to consummate the transaction. However, the consideration period could be extended by notification from the screening office to the parties that the Government needed additional time to consider the proposed transaction.

3. Upon receiving notification of the proposed transaction, the screening office would notify the appropriate U.S. Government agencies. The information, however, would be privileged. The departments and agencies to be notified would vary, depending upon the circumstances.

4. The departments and agencies so notified would have to inform the screening office urgently if they had any objection to the proposed transaction. Any agency might request a delay in consideration of the application and the convening of an interagency committee for discussion of the transaction.

IV. Screening Criteria

The following list of screening criteria is purely illustrative, and much further interagency consideration would be required to develop a definitive list.

(a) Possible effects on national security.

(b) The effect that the intended transaction might have on competition both domestically and internationally to the extent that it would affect the United States.

(c) The likely opportunity to influence public opinion in the United States as a result of the investment.

(d) The foreign policy implications of the intended transaction.

(e) The likely effect on future inward foreign investment.

(f) The importance to the U.S. firm of the transaction, taking into account the financial condition of the firm.

(g) The cumulative result of the proposed investment, including the extent to which this investment increases the exposure of a sector of the U.S. economy to foreign influence or the United States as a whole to foreign influence.

(h) In the case of investments in the form of debt, the extent to which they might give the investor leverage or de facto control in the U.S. company.

V. The screening process would not exempt the investment from U.S. laws, regulations, and administrative practices which would apply to investment in the United States, either by a U.S. citizen or a foreigner. It should be made clear to the foreign investor that he would have to satisfy all legal requirements.

Inward Investment Policy Review

Option 4 - Limit Official Foreign Investment in the United States

An upper limit would be set on foreign official acquisition of the stock and long-term debt of existing U.S. firms, e.g., 10 percent of equity and 15 percent of long-term debt. These limits would also apply to official foreign holdings in newly established enterprises. The limitation would contain a grandfather clause which would exclude forced divestiture or expropriation. This restriction on foreign official holdings would be imposed through new legislation which would include provision for a Presidential national interest waiver to give the Executive Branch adequate flexibility in administering it.

Two complementary elements would be required in conjunction with the imposition of a limit on foreign government investment as a necessary part of this option: (1) a comprehensive reporting and disclosure system for all foreign investment, and (2) prior coordination with the other OECD countries to assure a consistent policy affecting OPEC investments. A third element which would be desirable, would be the creation of a class of investment trusts for foreign governments which would provide them with an attractive alternative to direct holdings of corporate equity and debt. This class of funds would be provided for by legislation and subject to U.S. Government control in a manner similar to that of regulated investment companies for private investors. These funds would serve USG policy purposes by encouraging a broadening of the OPEC investment portfolio. (A policy including this feature is treated as sub-option A and the additional advantages and disadvantages relating to it are treated separately following those regarding the main option.)

Percentile limitations on official foreign investment would conflict with some of our FCN treaties. Accordingly, further study would be necessary to determine how potential treaty conflicts might best be handled, for example, by prior negotiation aimed at avoiding a treaty conflict, by renegotiation of relevant treaties, or by having the legislation exempt treaty countries. The first appendix to this paper contains a discussion of the FCN treaty issue.

If this option should be adopted, it would be desirable to invoke currently available authority to prevent foreign investors from rushing into the U.S. market ahead of the eanctment of legislation. Such authority is found in Section 5(b) of the Trading With the Enemy Act as amended; a legal statement on the Act is attached.

Advantages

-- Deals directly with our principal concern regarding the potential for politically unacceptable influence gained through major investment interest in U.S. firms on the part of OPEC governments.

-- Introduces no new restrictions on foreign private investment.

-- Does not overtly discriminate against OPEC countries.

-- Avoids need for prior screening.

-- Provides guidelines which remove uncertainty regarding recéption of OPEC investments.

-- Encourages the OPEC countries to develop broad and diversified investment portfolios.

-- Establishes a basis on which to seek a coordinated consumer country policy vis a vis OPEC investment.

-- Does not require that USG attempt difficult task of making judgments regarding which U.S. industries are vital to our national interest and which are not.

-- Involves the Congress in the establishment of the policy, thus allaying foreign government fears of Congressional repudiation of an Administration policy position.

Disadvantages

-- If applied to all countries, apparently conflicts with a number of FCN treaties (i.e., provision on national treatment for establishment and acquisition). If applied only in absence of such FCN treaty provisions, then issue of OPEC unhappiness over policy aimed almost entirely at them is intensified. (We have no such FCN treaty provision with any OPEC country.)

-- Administration of Presidential waiver provision could be troublesome in terms of foreign government pressures and potential violation of MFN principles .

-- Will be viewed by OPEC countries as aimed specifically at them in attempt to control their investment options, which could lead to some reductions in oil production.

-- Does not cover land sales, per se, which, while difficult to deal with in view of predominate role of State and local governments in land use questions, is a politically sensitive issue.

-- Submission of Administration legislative proposal could attract undesirable restrictive amendments; however, a bold Administration proposal in an area where Congress has expressed concern would appear comparatively invulnerable to the attachment of unwanted "Christmas treê" ornaments.

-- Could result in reduction of investment inflows.

-- Putting percentage limits on long-term investments could force OPEC countries to remain short-term investors, thereby increasing instability of international banking system.

<u>Suboption A</u> - <u>Limitation on Foreign Government Investments Combined with Special Investment Funds for Foreign Governments</u>

A logical adjunct to placing ceilings on direct foreign equity holdings of U.S. firms and of long-term corporate debt would be to create an additional attractive indirect channel for foreign government investment. Details on how such funds might be created and operated are included in the discussion section below. This suboption would present the following additional advantages and disadvantages to those of the main option: (The investment fund could also be used with other options.)

<u>Advantages</u>

-- Provides an additional channel for foreign official investment at the same time that direct holdings are being limited.

-- Is consistent with our goal of broadening the distribution of foreign government, particularly OPEC, investment and thereby limiting the extent to which oil producer investment is translated into political power.

-- Congressional approval is likely to be required to establish the investment funds; as a result such funds would have a Congressional blessing which alternative investments would not have.

<u>Disadvantages</u>

-- OPEC Government receptivity is not known and could be negative.

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-- Any appearance of giving incentives to government investors would be criticized at home and in other non-OPEC countries: conversely, omission of incentives would reduce the attractiveness of the funds as an alternative investment channel.

-- Making the funds in effect a favored avenue for foreign government investment could be criticized within this country as being contrary to normal U.S. Government-business relationships.

-- The funds would be powerful and influential forces and could have an unpredictable impact on international financial and equity markets.

Discussion

The proposed ceiling on direct foreign official holdings would actually affect very little OPEC investment based on our experience so far. Thus, it is aimed at potential rather than actual investment patterns.

With regard to possible conflict with FCN treaties it might be possible to make a case that the intent of those treaties was to deal with private not government investment. However, to avoid apparent conflicts with U.S. treaty obligations, we are excluding from the limitation countries with FCN provisions calling for national treatment on establishment and acquisition, while still covering all the OPEC countries. New FCN treaty negotiations would have to take the effect of this policy option into account by excluding government investment from a national treatment provision.

In addition to OPEC states, certain OECD states with whom we do not have FCN treaties (for example, the U.K., Canada and Australia) would also be affected. However, we do not anticipate massive official investment from those countries, and we would anticipate no special problems arising as a result of this.

The investment funds contemplated under the suboption would be subject to some limitation on the percentages of equity or debt that they could hold in a single company. Each such fund would be required to have separate management and no collusion among them would be permitted. Their use would be optional and in no way limit the choice of investment channels open to OPEC. Further, management of the funds would be divorced from direct control by foreign governments and would be independent of them in the exercise of voting rights obtained through the fund's equity holdings.

There should be no limit on foreign governments' indirect holdings of equity through participation in more than one of these specially created investment funds, since the dilution of control which would be provided by this device would be adequate protection against undue influence. Thus, a foreign government might participate in investment funds that together hold substantially more than 10 percent of the stock of a particular corporation. In that way, foreign governments could enjoy the economic benefits of a major shareholder while being divorced from management control.

Creation of such investment funds would have to be handled carefully in order to give them some appeal to foreign official investors, without providing undue special incentives. This could be accomplished by emphasizing the acceptability of such investments, a factor which is of particular importance to government investors. The establishment of such funds would probably require Congressional action, and legislation would give foreign governments Congressional blessing for such investments which they would not otherwise obtain. In a situation where the attitude of the U.S. Congress is a major uncertainty for foreign investors, such a blessing would be an important factor. Further, the existence of limits on direct foreign government holdings will itself act as an incentive to the use of the investment funds.

Coordination of consumer country policies toward foreign government investment would be essential for the success of this option and suboption. This would involve (1) coordinated arrangements for setting up the investment funds, (2) parallel registration and disclosure requirements, and (3) parallel limitations on direct foreign government holdings of equities and long-term corporate debt. This could be accomplished within the IEA or the OECD.

Uncoordinated consumer country inward investment policies could produce a snowball effect in which restrictions on OPEC government investment by one country could divert massive funds to another consumer country which would then be forced to enact even tighter restrictions. The end result could be a general level of investment restrictions so high that OPEC countries would be encouraged to cut back on oil production. The absence of coordination could also result in a channeling of OPEC investment to the consumer countries with weakest economies, such as Italy, which could not afford to match high levels of restrictions, and would thus give the OPEC countries very significant economic and political leverage in those countries.

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Suitable vehicles are available for early discussion of these issues in the IEA and the OECD, (e.g., the inner group of the XCSS meets in February, the new OECD investment committee will meet in February, and a new IEA financial group is about to be formed). Any unilateral modification of any of the consuming countries investment policy without consultations would threaten the unity of the group vis a vis the oil producing countries.

There have been clear indications that the oil consuming countries are willing, in fact anxious, to develop a coordinated strategy with regard to OPEC investments, and it is noteworthy that our Embassy in Bonn has reported that German Finance Minister Apel has publicly stated that OPEC investments have raised the requirement for serious vigilance and possibly legal barriers. He stated that there are limits to the amount and types of direct investment which the German Government would permit within the Federal Republic.

The reporting and disclosure system called for under this option may or may not require additional legislation depending on whether a comprehensive and effective system can be created from existing authority and reporting requirements. In any case, the reporting system could be put in place before action is completed on the other elements of the option.

Date: December 30, 1974

MEMORANDUM FOR: Assistant Secretary Cooper
Assistant Secretary Parsky

From: Deputy Assistant Secretary Willett

Subject: Critique of Foreign Affairs Article by
Robert Roosa et. al.

Attached is a draft summary critique of the recent Foreign Affairs article by Robert Roosa et. al. The economics are quite weak, and the authors are very vague on some important aspects of their proposals. However, the basic thrust of the mutual fund idea -- i.e. formation of some sort of institutional buffer between OPEC investors and oil consuming country firms and governments -- may be worth considering further as something which could benefit both producers and consumers.

cc: Under Secretary Bennett, Deputy Assistant Secretary
Cross, Mr. Willis

	Initiator	Reviewer	Reviewer	Reviewer	Reviewer	Ex. Sec.
Surname	Willett					
Initials / Date	/	/	/	/	/	/

Form OS-3129
Department of Treasury

DRAFT
Willett/Klock
12/30/74

Summary Critique of Mutual Fund Proposal
of R. Roosa, et. al.

The recent Foreign Affairs article by Roosa et. al. 1/ is very loose and vague in its basic analysis, its criticism of U.S. policy, and its presentation of the authors' own proposals. The discussion is useful, however, in that it at least touches on two major issues facing policy-makers.

-- The need to get OPEC to share the risk in lending to non-creditworthy borrowers; and

-- The need to shift real resources from consumption to investment in oil consuming countries, to sustain growth and to facilitate the ultimate real transfer implied by OPEC financial accumulations. The latter issue is dealt with much more explicitly in the paper. Indeed, the authors' view appears to be that the necessary transfer of resources from consumption to investment cannot occur without some mechanism for directly channelling OPEC financial flows into fixed capital formation. (Indeed, the authors more generally seem to have forgotten that capital is fungible.) As indicated below, this seems wrong. It may be worth noting, however, that Professor Machlap took a similar stance in a recent IMF seminar.

1/ "How Can the World Afford OPEC OIL?" Foreign Affairs, January 1975.

The authors base their proposal on the following line of reasoning:

1) OPEC accumulations are relatively insensitive to feasible reductions in oil prices (or OPEC terms of trade).

2) Existing investment outlets may not prove sufficiently attractive to assure continued high-level OPEC production. At the same time, existing institutions may not channel funds to the countries which most need to borrow.

3) In order to prevent the loss of real income in oil-consuming countries from causing a severe slow-down in longer-term growth, and to create the additional production capacity to make the eventual real transfer, additional investment must be put in place in consuming countries.

4) To solve (2) and (3), new institutional channels need to be created so as to channel OPEC surpluses into government securities or directly into productive investment in oil-consuming countries. The authors propose two sorts of funds to assist in this process.

First, they propose a fund for channelling OPEC funds into special issues of government securities. The authors duly note that such securities should not be excessively attractive, and that the flow of funds into them should not be such as to be disruptive to exchange markets and the workings of the adjustment process. However, they then go on to enumerate probable conditions for OPEC support -- a "dominant voice" in operations, exchange rate guarantees, and some form of indexing. Default risk is not discussed. While a variety of other recycling proposals are criticized in part because OPEC does not share in risks of lending, the authors do not indicate how their plan would differ in this respect.

The purpose to be served by such a plan is unclear absent some sharing of risk by OPEC. If the aim is to increase <u>total</u> OPEC investment, then the assumed alternative presumably would be reduced OPEC production. While there has been some willingness to cut back to maintain prices, it is not clear that inadequacy of investment outlets constitutes a real threat at this point.

If the purpose is to enable particular countries (e.g. U.K., Italy) to accomplish necessary borrowings, the scheme as presented does not appear to offer any great advantage over other proposals for the U.S., Germany, et. al. to underwrite U.K. and Italian borrowings. OPEC still gets "good" assets while the risk falls to the guarantors. Alternatively, the borrowing countries offer necessary guarantees -- they can do this now.

Second, the authors propose an investment trust, to funnel OPEC funds directly into fixed capital formation in consuming countries. (As noted above, there is an implication running throughout the paper that only in this way can the necessary resources be shifted from consumption to investment.) The fund(s) would involve purchases on behalf of OPEC members of special issues of shares of various firms in various oil-importing countries. There are several questions which arise:

1) The amount suggested is $10 billion, which seems very small compared to the magnitude of the expected OPEC surplus or the required additional investment.

2) The assumption is that the domestic investment generated would be <u>additional</u> to what would otherwise have taken place. Even with such a facility,

however, a shift of resources from consumption to investment will require appropriate macro policies in oil importing countries. With them the facility is of marginal significance in this context, without them it is ineffective.

3) The proposal assumes a substantial degree of self-denial on the part of OPEC. As set out, the funds would be run on strictly economic grounds, but with various restrictions designed to spread the funds across countries and types of firms (see attached Economist article for details).

Despite these difficulties, the general approach may be worth pursuing further. In particular, the interposition of such an institution between OPEC and individual boards of directors could help defuse some very tricky issues in the treatment of longer-term OPEC investments. It could also be attractive to OPEC since it would offer some anonymity and thus reduce risk of expropriation, blocking, etc. Whether a plan as highly-structured as that suggested by the authors could or should accommodate any substantial portion of OPEC investment flows is another question.

A Marshall Plan for Opec?

The best hope for 1975 is that the oil-producing and oil-consuming countries might agree on some mechanism for marrying the world's greatest short-term problem of excess (the huge surplus of oil producers' funds) with the world's greatest short-term problem of scarcity (industries in all the oil-consuming countries are starved for capital, and are consequently headed for depression). The January issue of Foreign Affairs includes a remarkable article which might contain the seeds of an Opec Marshall Plan that could help to invest the world out of disaster. It is a joint article by Mr Khodadad Farmanfarmaian (the chairman of the Development Industrial Bank of Iran, and an adviser close to the Shah), two distinguished Americans (former Under-Secretary of the Treasury Bob Roosa and Professor Carroll Wilson), Japan's long time one-man economics brains-trust Saburo Okita, and one of Bonn's most prominent backroom economic advisers in Professor Armin Gutowski.

They give two abrupt warnings. "The danger that one or more importing nations will simply not be able to pay for oil is immediate, within a matter of months." And the commercial banks' systems of North America, Europe and Japan cannot handle for much longer the task of transferring huge funds from the strong countries, in which oil-producers' balances are being placed, to the weaker countries which need the money. Ordinary recycling will not work. Apart from a rescue fund for the very poorest countries, the authors want two new mechanisms to make Opec investment in wilting rich countries economic.

First, an "Opec Fund for Government Securities". Each Opec country would put into this fund as much as it wished—ie, as much as it thought was commercially desirable. The fund would then be used to buy the direct issues of the governments of particular industrial countries that wanted to borrow. It would provide a forum for discussion of the market terms—sometimes including index linking against exchange rate changes or even inflation—under which direct loans could be made to countries in the worst plight. Without some such forum the loans are not going to be made to countries in such a state as Italy.

But it is the article's final proposal that looks the most important of all. This is that a family of investment trusts should be set up—perhaps ten trusts with an initial capital of $1 billion each. Their purpose would be direct investment through the market mechanism, but in an agreed way. Thus an Opec Mutual Investment Trust would "concentrate its purchases of equities, for example, on new issues authorised by the existing stockholders of incorporated companies in oil-importing countries", and on other special offerings of stock through which the issuing corporations would be inviting Opec participation in their stockholdings in a proportion judged appropriate by the existing shareholders and managements.

The five experts, who have discussed the project extensively with financial and government institutions in both the industrial countries and the Middle East, suggest the following rules for these trusts. First, in the interest of the Opec investors:

- Several trusts for different objectives, such as a capital appreciation fund, an income fund, a balanced fund, separation between real property and intangible property, possibly trusts with different geographical spreads.
- Percentage limits set within each fund for holdings in a given country, or currency area, or individual company, or class of company (ie, Class A or AA or AAA or whatever).
- Individual trusts could be open end or closed end, but the shares of these trusts would not be listed on any stock exchange since they could only be traded among the relatively small number of Opec countries. Each trust would be run by a management company in which the nominal stock ownership would be held by each interested Opec country. Boards of directors of the trusts to consist of representatives from the Opec countries, plus representatives of their investment advisers in New York or Zurich or London or whatever.

The rules that are suggested in the interest of oil-consumers include:

- No trust would buy shares that put total Opec holdings in any company above 10 per cent unless both the company's management and the government of the country approved. Any purchases or sales above $1m in any company's shares to be made only with the company's prior knowledge.
- The trusts would give prior notice to central banks when they intended to move more than $5m into or out of a particular country.
- Trusts would exercise voting shares with a view solely to protecting the value of any investment.

The economic and political attractions of these proposals are obvious. Economically, the industrial countries need to revive their capital markets and secure investment-led escape from the coming depression. It is no good borrowing from the Opec countries in order to consume, but it is sound economics to borrow from them in order to build up productive capacity that will provide the income to pay the borrowing back. This will be achieved only if the investment goes into what the market signals are the most productive places. This is the first properly market oriented scheme that has been suggested, and therefore the first that could work.

Politically, the purpose of the scheme is to replace confrontation by consensus. The consensus has been achieved in this scheme between one of the wisest economic advisers in the Middle East, one of the wisest in the Far East, and three wise men from the West.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

R c B

Office Correspondence

Date October ?, 1974

To Mr. R. Solomon

From Samuel Pizer

Subject: Walter Levy's Proposals for Dealing with OPEC Surpluses

In his remarks issued on September 23, Walter Levy paints a grim picture of the financial problems related to the new price of oil on the one hand, and the need to maintain the flow of oil from OPEC countries on the other. His preferred solution is the creation of a new financial organization with management shared by the principal consuming countries and certain OPEC countries. Such an institution would provide an investment medium for OPEC surplus funds, help in lending to weaker oil consumers, and (at least by implication) cause the OPEC countries to share some of the risks of default which otherwise might fall entirely on the stronger consuming countries. This is a reasonable proposition, and follows fairly closely the concluding section of my preliminary paper of September 6 on recycling.

Failing agreement on such an institution, however, Levy recommends that "the economically strongest oil-importing countries, which would obviously attract most of the investment of the surplus funds and trade of oil-producing countries, should consider how to limit the inflow of such funds to a level not exceeding substantially the deficit on their own oil balance of trade." This might in Levy's view "offer leverage in any negotiation for a voluntary agreement between these key importers and exporters -- ".

Levy alludes to the difficulties of shutting out OPEC funds from the capital markets of the major importers, but he seems to think it could be substantially achieved. More questionably, he seems to believe that whereas OPEC countries might hold down production if they are put in a position of confrontation, they might not do so if faced with a barrier against the kinds of investment they prefer. He puts forward no reasons for believing this, nor does he explain why a concerted move of this type by major importers that would strike at a vital interest of OPEC exporters would not in itself be the kind of confrontation that would provoke a strong response on the production side.

Whether any consideration ought to be given to the bargaining device of limiting OPEC access to certain financial markets depends first on whether such a threat would have any credibility. The principal actor among consumers would have to be the United States, and a variety of difficulties for this country is easily seen:

1) The guideline proposed is vague. The oil balance of trade is not the whole balance of payments impact of the oil price change; even if it were this guideline would allow an increase in U.S. debts to oil exporters of perhaps $25 billion in 1974, and perhaps an additional $30 billion in 1975. These figures themselves are subject to OPEC decisions on pricing and U.S. decisions on conservation. These amounts representing U.S. net oil imports are probably equal to more than half of the reserve accruals of all OPEC countries. This may be the upper bound of OPEC desires for U.S. assets in any case, so Mr. Levy may perhaps have in mind some more restrictive guideline.

2) Some such authority as the Trading with the Enemy Act would have to be invoked to prevent U.S. banks from accepting additional funds from the selected OPEC countries. Perhaps the same authority could be stretched to cover foreign branches, or even subsidiaries.

3) Perhaps the same authority could be used to prohibit U.S. residents from dealing in other financial assets with these parties.

4) The OPEC countries concerned could shift their funds to other banks, who could redeposit them in U.S. banks, or invest them in U.S. securities. To avoid this, or minimize it, U.S. banks or securities dealers might inquire into the beneficial ownership of any foreign funds coming in -- obviously a difficult if not hopeless task.

5) Unless such major alternative investment centers as Germany, Switzerland, and the U.K. adopted a similar strategy the leakage of funds through them to the United States would be easily achieved.

6) There would probably be even less recycling to weaker consumers, because with the strongest U.S. banking institutions out of the picture the remaining institutions would be less well placed to take on such risks.

7) If it were Mr. Levy's plan to apply this restriction to the funds of only certain OPEC countries, it might be even more difficult to implement.

8) Chaos in the Euro-currency markets and in foreign exchange markets would be an early and very likely result.

Before these financial difficulties emerged, however, there would in all likelihood be a sharp reaction by the OPEC countries affected -- they would surely regard even active discussion of such a plan as a threat to the safety of their existing assets.

I think there is much to be said for inducing OPEC countries not to attempt to place too much of their surplus in the United States, and also for measures that would tend to stabilize production at as low a price as can be achieved. However, the Levy proposal does not, in my opinion, solve any of the basic problems and could create new ones.

cc: Officers & Section Chiefs,
Div. of Int'l Fin.

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FOR RELEASE IN MORNING NEWSPAPERS, MONDAY, SEPTEMBER 23, 1974

The Impact of Exploding Oil Costs on the World Financial and Economic System
by Walter J. Levy

Even in the context of nearly runaway world inflation, the most dangerous single threat to international economic stability in 1975 will be the disruptive impact of the oil price explosion on importers' and exporters' balances of payments. The readjustment required is too rapid and huge for established financial market mechanisms. Nor can recycling be undertaken by the USA and a few other major importing economies alone. A few key OPEC Governments must be invited to share this responsibility through a new, specialised international financial mechanism -- or invited to consider the consequences if they refuse.

Oil Costs Cannot Be Sustained:

Since the beginning of 1974, the financial cost of world oil imports has gone on rising relentlessly. This is in spite of a slowdown in demand in what OPEC calls a price freeze. In fact, since crude oil prices were quadrupled between last October and January, OPEC Governments have raised average crude costs another third by imposed increases in participation charges to the western oil companies operating there. With the anticipated increase in tax rates and Saudi Arabia's further "non-negotiable" demands upon Aramco, this underlying increase is continuing. According to OPEC decisions reached on September 13, 1974 the added foreign exchange burden on importing countries amounts to an estimated $3.5-5.0 billion per year.

These exploding costs of oil cannot be borne -- now, or for years to come. There is no way that the OPEC countries, together. can accept payment of even half their 1974-75 oil revenues in imports of real goods and services. So the world's oil importers also considered together, can only really pay through trade less than half this year's oil bills.

Such imports would come mainly from the same few highly industrialized oil importing countries that will also receive OPEC oil funds for investments, thus leaving the oil deficit dilemma of other importers unchanged.

For the rest of the oil bill, the importers, perforce, must run into debt. OPEC, perforce, will accumulate balance of payments surpluses. In the year ending June 30, 1975, conservative estimates imply that OPEC countries may add between $30 and $75 billion to their surplus holdings of foreign currencies. Amounts of that order would be equal to about 75 percent of the total book value of U.S. direct foreign investments, accumulated over many decades and owned by many hundreds of private corporations. This OPEC surplus, by contrast, will arise in only these current twelve months. From then on -- until such time, if ever, as all these oil exporting economies can absorb all their oil revenues -- their surplus claims on the rest of the world's future will go on pyramiding. The annual amount substantially exceeds total US net foreign public and private long-term and short-term liquid assets. Also by July 1975 foreign exchange reserves of a handful of OPEC countries will probably be larger than those of all major industrialized nations combined.

Many Oil Debtors are Now or Will Become Noncreditworthy

This pyramid of oil debt, moveover, is unstable from the start. For only a handful of the debtors are creditworthy by any normal commercial standard. The United States, Germany, perhaps Japan, France, the U.K. -- only these major oil importers plus Switzerland have the absorbing strength, the range of business enterprise or the established money markets, in their economies to attract surplus OPEC oil funds seeking worthwhile investment. Essentially, the bulk of the OPEC surpluses will be invested in the USA and these few other economies. Their money has nowhere else to go. But these oil surpluses arise from debt being incurred everywhere else -- by the less creditworthy rest of the world, from Italy right down the range to India. How can these poor credit risk countries be lent back the money to pay for the oil they are currently consuming?

Oil Debt Would Swamp Financial Markets

Action needs to focus on this transfer problem here and now, in 1974-75. It is as immediate as it is enormous. The abruptness and sheer dimensions of this surplus/deficit imbalance are such as to swamp potential adjustment through world market mechanisms, financial or commercial. It is building up too fast for the timelags of response in established money markets. Even if commercial or political pressure had been able to force reductions in OPEC's cartel price as large as any optimist could dream, this imbalance would still have remained unsustainable by conventional means. The amounts to be transferred are in any case just too prodigious. And in fact, oil prices have not fallen; oil costs are continuing to rise.

This overload on money markets is not simply "technical". The problem that has strained the practices of conventional banking is of Arabs lending short to Western bankers obliged to lend long. But interest rates are adjusting. OPEC governments are beginning to lend longer. The risk of sudden withdrawals can be handled by mutual support between commercial bankers; by the backing of central banks' swap arrangements. Risks remain; but this technical problem should be manageable.

But these adjustments through conventional money markets, now government reinforced, do not bear on the central issue. The world needs continuing oil supplies in volumes that at today's cartel price most countries cannot pay for, and are unable to borrow from any conventional money market. A few OPEC countries are exacting huge claims from all importers; and no commercial banker would advise these governments to accept promises to pay from most of their debtors. The commercially prudent places to put their surplus funds are equally few - the key economies of the West.

U.S. AND GERMANY CANNOT HANDLE RE-CYCLING ALONE

Clearly, inter-governmental lending back to most of the importers is essential. But immediately, the number of western governments in a position to do so shrinks to two, the USA and Germany. (For the few other importers receiving OPEC deposits, these will probably no more than offset their own current deficits.)

These two western countries are in surplus through trading strength and investment creditworthiness. It would seem commercially, psychologically and politically unacceptable for them to take the sole responsibility of holding OPEC loans at market rates and re-lending these funds to a range of poor risk international borrowers. This could develop into a massive, uncovered aid operation by the USA. Many oil importers, especially developing countries, would inevitably default. The money lent would be OPEC funds. But it would have been lent on American and German credit. OPEC would not expect the default to be passed on back to them.

PRODUCERS PREFER OIL IN THE GROUND TO DIRECT EXPOSURE TO CREDIT RISK

Nor could OPEC surplus countries themselves be relied on to recycle these oil funds directly to needy oil importers on any dependable or adequate scale. To accept and hold dubious currencies, or re-lend their surpluses at nominal or uncommercial rates, requires more financial sophistication, let alone goodwill, than importers can expect.

Faced with the probability that much of their surplus would simply accumulate as bad debts, there are strong currents in OPEC opinion that would prefer to cut back their production, rather than exchange a wasting national resource for what might turn out to be worthless paper.

It is true that several OPEC members have made arrangements with a variety of importing countries in order to assist them in their oil financing. But this effort is neither comprehensive nor systematic. Moreover, the distribution of funds among the different importing countries and their relative size are woefully inadequate even to begin to cope with the world's oil trade deficit problems.

Intellectually perhaps arguments can easily be advanced that unless an exporter believes that value of oil will rise faster than market rates of interest, it would be unwise to leave this oil in the ground. Then in theory, in a period when market interest rates are negative in real terms not even matching inflation, any such oversophisticated reasoning is meaningless. But at all times, this merely economic approach entirely fails to appreciate the real range of motivation, psychological and political, of these (and other) governments in settling policy regarding vital national resources.

That motive for a cutback of production would be more rational than attempts to force excessive prices up even further by cartel pro-rationing. But the danger, and the disruptive effect on an already damaged world economy, could be identical. That danger - to exporters as well as importers - must be avoided. In particular it must not be allowed to arise simply for lack of international financial mechanisms designed to handle this unprecedented situation.

THE U. S. MUST LEAD JOINT ACTION BY KEY GOVERNMENTS

Only the USA can lead the few key importers and key exporters towards constructing such a mechanism. The United States and these other importers should approach the three major producing countries of the Persian Gulf (Saudi Arabia, Iran and Kuwait) to present the importers position as it emerges from their own assessment, before OPEC's position becomes irretrievably frozen. The longer we delay such an approach, the more will the present revenue flow become either built into the budget and foreign expenditure flows of producing countries or result in a massive accumulation of foreign reserves. Once that happens, the producing countries would be much less inclined to listen to the importing countries and to agree to the essential adjustments in their oil-pricing and financial policies.

To be manageable, the financing burden for the oil balance of trade deficit for the large and most likely increasing number of needy oil importing countries would just have to be shared in an organized manner among the oil-importing countries led by the United States and Germany, and by OPEC, (especially Saudi Arabia and Iran).

This would require the establishment of a new international financial organization that would not totally commit and depend upon the resources and the credit of the importing countries, the World Bank or the Monetary Fund. The share of each group of donor countries, and the selection of those nations that would qualify for financial aid, should be established on the basis of agreed criteria. Inevitably, the bulk of the money would have to be OPEC surplus funds. Alternatively, or as a supplement, efforts could be made towards some organized arrangement whereby needy importing countries could "pay for" their oil imports partly in their local currency, with restrictions on its convertibility and use as, for instance, in the case under Public Law 480 U.S. Exports of Food.

However, in any case the importing countries could be expected, as in the past, to use their own foreign exchange to pay the producing countries for at least part of the cost of their oil imports and draw on international financing only to cover the difference between that amount and the unsustainable burden caused by the unilaterally imposed OPEC cartel price.

As oil surpluses build up this year, such an approach may increasingly commend itself to the responsible leaders of "Gulf OPEC". Not only the Shah, but also the Oil Ministers of Saudi Arabia and Kuwait have at times hinted at readiness for such consultation. Great sensitivity will be needed in approaching the delicate subject of managing what is immediately OPEC's money, whatever its ultimate worth or worthlessness. But the prestige of such an invitation to joint financial responsibility to world finance should not be under-estimated either.

OPEC Needs to Face the Alternatives

Nevertheless, the initiative might fail, these producing countries, regardless, might still pursue a policy on oil supplies, pricing and surplus asset management that would inevitably jeopardize not only the economic political, and strategic well being of the oil-importing countries, but ultimately also their own survival. The United States should make abundantly clear to these OPEC leaders that in such circumstances the US and its partners would have no alternative but to protect themselves. Planning on a coordinated basis among the most relevant importing countries for meeting such a challenge must begin now.

In this planning, the economically strongest oil-importing countries, which would obviously attract most of the investment of the surplus funds and trade of oil-producing countries, should consider how to limit the inflow of such funds to a level not exceeding substantially the deficit on their own oil balance of trade. This would involve difficult issues of monetary and trade policies, further complicated by the existence of the eurocurrency market. "Petrodollars" are not easy to identify; and many financial intermediaries have vested interests in assisting this anonymity. Any such control would be hard indeed to administer. Measures to be taken would probably have to encompass a broader range of foreign capital movements. But it is imperative that this possible alternative course of action be given the most intensive study.

Such limitations on the free flow of surplus oil funds, if they had to be invoked, would at least help to diversify such flows in a manner that would be more responsive to the financing needs of the oil-importing countries. Most important, even the mere warning that the importing countries may consider and if necessary apply such policies could offer leverage in any negotiations for a voluntary agreement between these key importers and exporters — and in securing acceptance from the rest of OPEC.

No certainty can be claimed for this approach, but the magnitude of the danger has not been over-stated. Indeed, most estimates so far made have been based on assumptions about crude oil costs that have proved over-optimistic. Nor does any lower-level initiative seem commensurate to the size and immediacy of the problem. The underlying danger to the world economy, so long as existing financial mechanisms remain inadequate to financial transfers of this new order of magnitude for oil is that the OPEC countries might still be tempted, sooner or later, to cut back production. Any such response by the oil-producing countries would dramatically illustrate the inescapable interconnection between the world's oil supply and over-all finance problems. It would also make it clear that neither the importing nor the producing countries can afford to ignore or avoid facing the issues that now confront us. In such circumstances, the conclusion is inevitable that in order to avoid a confrontation it is imperative to work towards and achieve an equitable accommodation of interests of all parties involved.

APPENDIX 10.—ADDITIONAL MATERIAL BEARING ON DIVERSE CONCERNS AND ISSUES RE: OPEC AND OTHER FOREIGN INVESTMENT

De artment of the Treasury

Office of the Assistant Secretary (Trade, Energy, and Financial Resources Policy Coordination)

Office of Financial Resources Policy

room. date. Mar. 29

Subject: Material on Advance Consultations on U.S. Investments by Foreign Governments.

Attached is the requested material for the Committee on Foreign Investment.

DVP

~~David V. Pritchett~~
room 4120
ext. 5063

CFI 11-

Consultation Agreements with Major Governmental Investors

Summary

The Administration indicated in Congressional testimony that it would negotiate "procedures with the principal foreign governmental investors for advance consultation with the U.S. Government on prospective major direct investments in the United States."

The Saudis agreed to close consultation with the USG on significant "productive undertakings" in the United States. Kuwait, the UAE, and Qatar also agreed to investments. These four governments have indicated they currently have no plans for significant direct investments in the United States.

After Iran objected to the possible discriminatory treatment of being singled out by the USG for a consultation agreement, we noted that our policy applies to all nations which invest abroad and that these other nations also have been informed of USG policy. With that understanding, the Iranian government has agreed to consult with the USG on major investments in the U.S.

Saudi Arabia

Saudi Arabia ageed that they would consult closely with the USG on significant "productive ventures" in the U.S. that they planned. This agreement took the form of a joint communique, issued by Treasury Secretary Simon and the Saudi Minister Abu al-Khail in February, 1975.

Kuwait

In August 1975, Minister Ateeqi advised Treasury Secretary Simon that Kuwait does not plan to go above 10% ownership of any U.S. company and agreed that, if this limit is to be exceeded, they would consult with the U.S. Also, in noting their goal of shifting away from money-market participation, he indicated their interest in moving to a greater degree into equities.

Qatar

In September 1975, the government of Qatar, in discussions of Minister Khaykh Abdul Aziz and Assistant Secretary Parsky, agreed to advance consultations for significant investments in the U.S. Qatar stated that their small investments in the U.S. consist of only portfolio investments.

U.A.E.

In a meeting with Secretary Simon on March 4, officials of the U.A.E. and Abu Dhabi -- the emirate within the U.A.E. Federation with the bulk of the investible funds -- reiterated their agreement, expressed in a prior meeting with Assistant Secretary Parsky, to consult with USG if they comtemplate making a large investment in the U.S. Minister Habroush stated in March that he did not anticipate such investment in the foreseeable future.

Iran

After the USG noted that its policy concerning foreign investments in the U.S. was not discriminatory, the Iranians agreed to consult with the USG on major investments in the U.S. The USG emphasized that our policy is designed to provide a mechanism through which potential problems of particular investments in the U.S. could be avoided and is not intended to raise a new barrier to foreign investment.

Draft: D. Pritchett
Clearance: J. Newman (3/29)

THE SUNDAY PLAIN DEALER, MAY 28, 1978 SECTION TWO—3

CHASE

Chase World Information Corporation

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New York, New York 10048

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"In 1980 the major oil-exporting countries will have a balance-of-payments surplus on current account of the order of $115 billion."
Jacques de Larosière
Managing Director
International Monetary Fund

Add $115 billion to the already gigantic surplus of income over expenses in the oil-rich Middle East and it's easy to forecast an almost limitless supply of Arab wealth looking for a profitable place to go.

> What is not easy for anyone -- in or out of the Middle East -- is to identify the specific investors, public and private, whose interests, resources, past performance records, and investment preferences could be relevant to your own business strategies.

That kind of intelligence-gathering is clearly indispensible for any company that would like to be aware of the prime market for capital in the world today. It is also immensely time-consuming, exorbitantly expensive -- and by no means assured of success.

Fortunately, this need no longer discourage you, for with this letter Chase World Information invites you to reserve a copy of

<u>ARAB INVESTORS: WHO THEY ARE, WHAT THEY BUY, AND WHERE</u>

This special report can save you many months of research by pinpointing an extensive list of public and private investment institutions, commercial firms, consortiums, and private family holdings in the Middle East. It is detailed...illuminating...the first and only compilation of its kind.

Volume I, now available, covers investment outside the Arab world. Volume II, to be published next spring, focuses on investment within the Arab world. Either volume may be ordered separately, but there is an important price advantage for those who order both volumes <u>simultaneously and in advance</u>.

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Chase World Information is on familiar ground in the Middle East. Arab investors know and respect Mideast Markets, the newsletter we published for years. They are equally familiar with our extensive series of in-depth reports on economic opportunities in their region.

Moreover, they also know John Law, author of ARAB INVESTORS. As a former bureau chief for U.S. News and World Report, former CWIC Vice President, and author of Arab Aid: Who Gets It, For What, and How, Mr. Law has lived and traveled in many Arab countries and has earned a solid reputation for reporting and analysis.

Because of this background and expertise -- and because Mr. Law conducted all his interviews personally -- we were able to obtain information that until now has been closely guarded. Even more to the point, we knew which questions to ask; we knew who would have the answers; we knew how to follow leads; how to separate rumor from fact.

You may be surprised by some of our findings. In Volume I, for example, you'll be introduced to some of the most prominent Arab investors...to some policies that roundly refute accepted notions of how Arab investors manage their affairs. Among these investors are:

--a Kuwaiti entrepreneur who bought an ailing U.S. construction company and, within a short time, doubled both its sales and its profits

--a shipper from Qatar (few Westerners have ever heard of him) who bought the famed Ritz Hotel in Paris; and a Saudi, whose name is hardly known even in his own country, who now owns two deluxe hotels in Florida

--a man who says he is considering "a major $300-million acquisition in the United States" in petrochemicals

--the two families that share ownership of Saudi Arabia's largest private bank (Its profits are estimated at $100 million a year.)

Our report offers information regarding the strategies of a large number of financial institutions, and much of the time we'll be able to tell you who makes the decisions for these institutions.

Each volume of the report surveys the background, current status, and possible future prospects of Arab wealth, and describes each Arab financial institution in terms of

past investment activities...current resources... preferred investment criteria, including whether investment is for portfolio or for active management... geographic preferences, if any...probable future priorities

PLUS, of course, such practical data as names, titles, functions, addresses, telephone and telex numbers. Finally, a series of Appendixes presents, among other pertinent information, a variety of charts, tables, and graphs illustrative of recent investment history.

Volume I (on foreign investment) is available immediately. Sending in your order now will assure you of a copy. And if, at the same time, you order Volume II (on investment within the Arab world), we can guarantee you a substantial saving.

Each volume will be priced individually at $345.00. However, if ordered and paid for now, Volume II will be sent to you upon publication for $241.50, a 30 percent discount. If payment accompanies your order for Volume I, an additional 5 percent discount is applicable.

I hope you will use the enclosed form to advise us of your interest.

Sincerely,

P. D. Wieland

P. D. Wieland
Vice President

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

December 21, 1979

Mr. Steven McSpadden
House of Representatives
Rayburn Office Building
Washington, D.C. 20515

Dear Steve:

This is in further response to your inquiry regarding the procedures under which the Federal Reserve Bank of New York tenders for or purchases U.S. Government securities for the account of foreign monetary authorities and central banks. You have expressed special interest in the terms and conditions applicable to transactions by Saudi Arabia.

The following procedures have applied and continue to apply to cash subscriptions by all foreign authorities, including Saudi Arabia. The U.S. Treasury periodically sells bills, bonds and notes at auction, with provision for both competitive and noncompetitive tenders. Such offerings are regular financial transactions of the Government and offer market-determined yields to foreign and domestic investors. The offering circular issued by the Treasury indicates a specific amount offered to the public, with the notice that additional amounts may be issued at the average price of the accepted tenders to Federal Reserve Banks as agents for foreign and international monetary authorities.

The Treasury allots competitive tenders in each auction after subtracting from the public offering the volume of noncompetitive bids from the public and from foreign authorities exchanging their holdings of maturing securities. The allotment is made by accepting bids with the lowest yield (highest bid) first, ranging upward to higher yields to the extent required to cover the amount being sold. The amount accepted at the highest yield is prorated among bidders at that yield, if necessary.

Noncompetitive tenders for the account of foreign monetary authorities are awarded at the average price determined by competitive bidding. Tenders for additional amounts by foreign authorities are subject to review by the Treasury, and the Treasury reserves the right to reduce the allotment should the demand from foreign official accounts

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be inordinately heavy. The arrangements with Saudi Arabia have provided that Saudi Arabia will give two days notice to the Federal Reserve Bank of New York should it wish to sell securities acquired under the above procedures, giving the Treasury the opportunity to bid for such securities at the prevailing market price.

The Federal Reserve Bank of New York may also purchase outstanding U.S. Government securities for the account of foreign authorities or sell securities held for the account of such authorities. If foreign authorities wish to sell securities prior to the maturity date, the Federal Reserve may purchase the securities directly from the authorities at market prices when such purchases would be appropriate for the execution of monetary policy. Alternatively, the Federal Reserve may offer the securities for sale in the market for the account of foreign authorities. These authorities are advised that it may prove difficult to purchase or sell very large amounts of a particular maturity in the market at one time, and that it is important for foreign authorities to space maturities of Treasury bills and other short-term securities to allow ready marketability. The Federal Reserve Bank has undertaken to preserve the confidentiality of all transactions under these procedures.

I hope that this is of assistance to you.

Sincerely yours,

Gil Schwartz

Gilbert T. Schwartz
Assistant General Counsel

The arrangements are applicable to new issues of Treasury securities bearing a maturity of one year or more, including in particular issues having maturities of two years which are being offered on a quarterly basis. These issues may be sold on a yield auction basis (as in the case of the two-year notes described in Circular 7526) or on a price auction basis with an announced coupon rate (as in the case of the 15 month and 4 year, 4-month notes described in Circular 7534).

As indicated in Circular 7526, the two-year notes are typically sold at auction on a yield basis, and public bidders must state the yield they will accept on the basis of a percentage to two decimal places. The coupon rate will be set after the auction on the basis of the average yield on accepted public tenders and to produce an average price at or below par. In the current auction the resulting coupon rate was 7.25 percent and the resulting price was 99.872. Such offerings are regular financial transactions of the Government and offer the same market-determined terms to foreign and domestic investors. The circular indicates a specific amount offered to the public, with the mention that additional amounts "may be issued at the average price of accepted tenders to Government accounts and to Federal Reserve Banks for themselves and as agents of foreign and international monetary authorities."

With respect to future offerings under the new arrangements, as soon as a Treasury announcement of the offering is released, the Federal Reserve Bank of New York is prepared to telex to foreign monetary authorities the terms of issue, auction date, and settlement date of the offering. If a foreign monetary authority is interested in the offering, it would notify the Federal Reserve Bank of New York of its interest, indicating the amount involved, prior to the auction.

As soon as the auction is completed, the Federal Reserve Bank would inform the purchaser of the average price of accepted public tenders at the auction, and the amount to be paid in Federal funds on the settlement date for the issue.

Following the auction, the Treasury will report in a lump sum the amount sold to U.S. Government accounts and to the Federal Reserve Bank for itself and for the account of its customers, but will not reveal the amount awarded to any individual subscriber in order to preserve confidentiality.

In the event that Saudi Arabia should wish to sell the securities purchased under these arrangements prior to their maturity, it would give two days' notice to the Federal Reserve Bank of New York. In such event, the Treasury would have the opportunity to purchase such securities at market prices. If such a direct purchase were not effected, the securities would be sold in the market, or, as in all such cases of central bank transactions, they might be purchased by the Federal Reserve Bank for the System Open Market Account at market prices if it fitted with reserve management considerations. The use of any of these alternatives could depend on the size and timing of the proposed sale, taking into account the effect on the market and market prices of any such sales. In all cases, the arrangements would be for the mutual benefit of all parities concerned. The arrangements could serve to protect the Government securities market from the impact of an unexpected large sale, and could also avoid the possibility that a large sale in the market might adversely affect the price that a seller would receive. The Federal Reserve undertakes to preserve the confidentiality of all transactions under these procedures.

Summary of Federal Reserve Bank of New York Letter of December 24, 1974

In his letter of December 24, 1974, Mr. Debs, First Vice President of the Federal Reserve Bank of New York, stated to the Saudi Arabian Monetary Agency proposed arrangements for the future purchase of U.S. Treasury securities.

The arrangements would apply to new issues of Treasury securities with a maturity of one year or more. The letter describes the process by which securities are auctioned. The New York Reserve Bank would advise SAMA of the terms of proposed issues and SAMA would notify the Reserve Bank if it were interested in the offering.

If SAMA desired to purchase securities, the Reserve Bank would inform SAMA of the average price of accepted public tenders at the auction and the amount to be paid by SAMA. It was indicated that Treasury will report in a lump sum the amount of securities sold to U.S. Government accounts and to the Federal Reserve Bank but would not reveal the amount sold to individual subscribers.

The letter also indicates that in the event SAMA wishes to sell the securities purchased prior to maturity, it would give two days notice to the Reserve Bank. This would enable the Treasury to offer to purchase the securities at market prices. If Treasury did not purchase the securities, they would be sold in the market or, as in all cases of central bank transactions, might be purchased by the Federal Reserve. The arrangement would be mutually agreed upon and would serve to protect the Government securities market from the impact of an unexpected large sale and to avoid the possibility that a large sale would adversely affect the price received by the seller.

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Summary of Letters of January 13 and 14, 1975

In its letter of January 13, 1975, to the Saudi Arabian Monetary Agency the Federal Reserve Bank of New York discussed arrangements concerning note offerings by the U.S. Treasury. The letter indicates that arrangements between the Reserve Bank and SAMA relating to the purchase and sale of U. S. Treasury securities will apply to new issues of securities having maturities of one year or more and will not apply to securities purchased through competitive bidding or from the secondary market. The Reserve Bank stated that it would notify SAMA of proposed Treasury issues, tender bids for SAMA on a non-competitive basis at the average price of the accepted public tenders, and hold in safekeeping the securities purchased by SAMA. It was indicated that SAMA would notify the Reserve Bank 48 hours prior to a proposed sale of securities in order to give Treasury the opportunity to bid for them.

In its letter of January 14, 1975, SAMA agreed to the arrangement.

Date: 10/19/76

TO: Financing Group

The special arrangement for allotting additional amounts to foreign accounts yields erratic amounts of cash. It started as a concession to one country which happened to be skittish about foreign specials. It proliferated, for one reason at least, because the FRB NY likes to be a "full-service bank" to its foreign customers.

Do we want to continue the practice? Attached is a draft of an options paper.

Attachment

DAVID MOSSO

Room 3134 Ext. 2112

DATE: October 18, 1976

SPECIAL ARRANGEMENT FOR FOREIGN CENTRAL BANKS AND INTERNATIONAL MONETARY AUTHORITIES ON MARKETABLE OFFERINGS

Background:

For some years now, we have had a special arrangement whereby foreign central banks and international monetary authorities could be allotted new marketable issues, at the average price or yield, over and above the amount allotted to the public. Initially, the arrangement was afforded to Saudi Arabia, apparently being negotiated with that country as part of a package of technical and financial accommodations. It was quickly expanded to include all OPEC countries, and then, expanded to include the full gamut of foreign central banks and monetary authorities.

Usage:

Net new money to the Treasury, per marketable issue under this arrangement, has ranged from under $50 million to in excess of $350 million recently in the shorter maturity range. We have been seeing increased interest in intermediate maturities up to five years.

Problem Potential:

Initially, and perhaps currently, the add-ons under this arrangement have been viewed as helpful, given large Treasury cash needs, despite the fact that such add-ons could not be counted on in our financial planning.

The recent experience with the September 30, 1978, 2-year note issue is illustrative of the potential problem posed by this arrangement. In that offering, given our very comfortable cash balances projected for the near term, and being influenced by the tight debt limit, we sought only $.8 billion of net new money from the public. At the auction, foreign central banks came in for $355 million under the special arrangement. We were advised by the Federal Reserve Bank of New York that another country would have participated in the offering under the special arrangement for another $400 million, but had been put off by the Fed because of the Treasury's debt limit problem. If the latter foreign central bank had been allowed to participate, the total add-on in the auction would have been $.8 billion or about the same amount as was raised from the public. As it was, the central bank with the interest for $400 million was awarded that amount of a September 30, 1978 market-based special note on October 1 at the average yield established in the auction of the 2-year notes. Thus the Treasury raised twice as much as it had determined it wanted.

Suggested Remedies:

(1) Eliminate entirely the special arrangement, either by forcing foreign central banks into the competitive auction, or by allowing the Federal Reserve Bank of New York to enter non-competitive tenders on their behalf in the auction.

Pro:

Under either variation the Treasury would be relieved of the uncertainty of the cash raising effect of its public offerings, and foreign central banks would get a market rate.

Con:

Foreign central banks would not be completely assured a full allotment. Under the non-competitive bidding arrangement, they might be reasonably assured their full allotment, but their participation on this basis could result in competitive bids being awarded on an unseemly small proportion to the offering.

Comment:

The Federal Reserve Bank of New York would be in the tenuous position, of (a) under the competitive bid arrangement, determining the level of expected competitive bids in order to enter a bid to fill the foreign central banks' orders, such determination being based on dealer perceptions of the market for the publicly announced amount of the new security; and (b) under the non-competitive bid procedure, of being accused, along with the Treasury, of failure to inform the market of such preferred interest in the security.

(2) Eliminate the special arrangement and substitute for it the availability of market-based special issues.

Pro:

This would eliminate the market impact of foreign central bank activity under the special arrangement and would insure the affording of competitively determined rates to the foreign authorities.

Con:

This would provide no solution to the Treasury's problem of unexpected cash inflows and outflows.

Comment:

The Treasury's long-term experience with foreign special non-marketables has been generally unfavorable, owing to cash coming in at a time when it is not useful and the cash flowing out at a time of heightened Treasury cash needs.

(3) Limit the special arrangement to the Saudi's or a small number of countries.

Pro:

By limiting the number of countries involved, the Treasury could conceivably determine, through consultation with the individual foreign authorities, the future potential cash flow involved under the special arrangement.

Con:

Selectivity under the special arrangement could give participating foreign central banks a competitively advantageous market position, vis-a-vis, both other foreign central banks and also our own domestic market participants.

Comment:

Initial selectivity and changes therein could place the Federal Reserve Bank of New York in the position of being a mere functionary of U.S. foreign financial policy.

(4) Have the Federal Reserve Bank of New York manage the foreign central bank portfolio comprehensively as regards Treasury securities, i.e., determine in consultation with each foreign central bank or monetary authority the desirable proportionate total and maturity structure of its holdings of Treasury securities. All such investments in Treasuries would be in market-based specials except for unexpected or transitory fund flows, the latter being invested in repos or very short Treasury marketable bills until such time as a place in the desired portfolio structure could be determined.

Pro:

Firm foreign interest in Treasury securities could be determined in advance of the offering announcement and our plans for raising cash could be so influenced and indicated in our public announcements. Unexpected or transitory funds from foreign central banks or monetary authorities would be neutralized in the market until such time as they could be absorbed in the portfolio structure of the foreign authorities. If such flows would otherwise interfere with FOMC actions, the Treasury could afford investment of the funds as is currently the case.

Con:

It seems apparent that for many countries comprehensive or systematic portfolio management by the Federal Reserve Bank of New York would be unacceptable or subject to such ad hoc variations that it could be useless from the Treasury point of view.

Comment:

If foreign authorities are to be afforded special investment privileges over and above those offered to domestic individuals and institutions, there should be a demonstrable benefit to the Treasury either directly or at least through a positive contribution to the stability of the market for Treasury securities. Since the market performs most efficiently with the most certain knowledge available, Treasury financing operations should be planned with the market's certain knowledge of foreign activity to the extent possible.

Date: February 5, 1974

MEMORANDUM FOR: SECRETARY SHULTZ
THROUGH: Assistant Secretary Hennessy

From: Thomas D. Willett TW

Subject: Economic Policy Problems Arising from the Current Oil Situation

DECLASSIFIED
AUTHORITY: W[illegible]
DATE: 8/17/79

Based on the economic analysis we have been doing on the effects of the current oil situation, I have prepared the attached paper which summarizes our analysis from the perspective of its implications for economic policy.

~~Principle~~ Principal conclusions include that due to the oil situation:

(1) there is a need for countries to agree to follow more expansionary macro economic policies than they otherwise would have;

(2) attempts by a large number of oil importers to stimulate exports to offset increased oil payments could have severe adverse consequences for the international economy;

(3) consequently, U. S. guidelines for floating rates should be supplemented by a short-term agreement to cover increased oil payments by net increases in international borrowing.

The attached paper takes the current range of oil prices as given and discusses how best to adjust to them. We have also been doing a good deal of work on the outlook for oil prices and alternative strategies for pushing them downward. I shall prepare a memo on this following our oil consultants' meeting.

A major result of our analysis is that, if they behave cooperatively, the OPEC cartel could withstand any economic pressure which the oil consuming nations might be able to put on them. On the other hand, internal squabbles within the major OPEC producers could well lead to a breakdown of the cartel over the next year or two in response to relatively modest potential excess supplies.

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Department of Treasury

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This strongly suggests that in terms of getting oil prices down over the next year or two it would be extremely counterproductive for the U. S. to take any actions which would smack of confrontation. This would only increase the likelihood that the OPEC countries could reach agreement among themselves to curtail production in the face of reductions in demand.

A second major point is that we should be very wary of attempting to negotiate an international commodity agreement on oil, especially over the near future. It appears likely that prices will decline as a result of market forces over the next several years, and it could be quite costly to lock ourselves into anything like the current levels of oil prices -- even if the OPEC countries would agrae to a dollar or two reduction of price as part of a long-term agreement. It is certainly worthwhile trying to "talk down" the price and convince the Arabs that thair longer run interests lie in this direction; but, if the price of such a rollback is an international commodity agreement, we should be extremely cautious about attempting it. Indeed, we would be wise to turn as cold a shoulder as possible toward international discussions of a commodity agreement.

Attachment

cc: Messrs. Simon, Volcker, Bennett, Fiedler, Worthington & Woodworth
Cross, Larsen, Syvrud & Widman

Some Economic Policy Aspects

of the Current Oil Situation

Thomas D. Willett
February 4, 1974

The cutbacks in oil production by a number of the OPEC producers last year raised the prospect of severe damage to the economies of the rest of the world. In September of 1973, world consumption and production of oil were in approximate balance. Large cutbacks in production raised the prospect of severe shortages of oil in importing countries and consequent sharp reductions in production and employment. The decisions of Christmas week to expand production but at a considerably higher price has substantially changed the situation for most countries. The major concern is no longer the direct effects of oil shortages on the operation of the world economy but rather the monetary and international financial implications of the huge increase in oil prices.

A number of countries will continue during the first quarter of 1974 to feel the effects on domestic output and employment of the reductions in Arab oil production. However, the combination of reduced demands for oil, induced in part by its high prices, and increase in Arab production from the September levels appear to have eliminated the gap between oil demand and supply. If the embargo is lifted and further production increases take place, a substantial potential for excess supplies could even develop. Thus, for the remainder of 1974 the primary problem for the world economy caused by the oil situation will be the consequences of the current prices of oil rather than physical shortages.

1. Domestic Economic Effects

These price effects on the domestic economy, while less devastating than large physical shortages, will present a considerable worsening of most countries' economic situations. The large change in the price of oil will stimulate a considerable reallocation of domestic resources.

Costs of energy intensive activities will rise considerably relative to those of other goods and services, and the process of market adjustment to these changes is likely to lead both to temporary increases in frictional unemployment and losses of output, and also to increased cost push pressures on domestic prices. For the typical industrial country, this worsening of the trade-off between inflation and unemployment appears likely to reduce the rate of real economic growth by an amount on the order of one percent and raise the rate of price increase by two to three percent. (This figure is officially estimated to be lower for the U. S., although the Troika forecast seems quite optimistic on this score.) For most countries the induced fall in demand for domestic production seems likely to be greater than the growth of production. Japan is probably the primary exception. Thus, somewhat more expansionary domestic macro-economic policies will be required to offset the drain of purchasing power from the domestic economies generated by increased oil bills. It is important that countries agree that despite the accelerated rate of inflation, sufficiently expansionary policies should be followed so that unnecessary unemployment will not be generated domestically nor exported to other countries. Likewise, coordination is needed to assure that the policies followed by individual countries to alleviate the micro-economic problems of particular industries not complicate further the micro-economic problems of other countries.

2. Effects on the International Financial System

The greatest problems generated by the current level of oil prices, however, concern their effects on the international payments situation. Maintenance of the current structure of prices and exchange rates would imply what is probably the largest, rapid change in the structure of international payments positions that the world has ever seen.

In the past, changes in major countries' trade and current account positions of only a few billion dollars have been the source of major international concern. In contrast, projections of the current situation for the remainder of 1974 indicate an increase in the current account position of the OPEC countries on the order of $50 billion matched by a deterioration in the position of the less developed oil importing countries of almost $10 billion, and a decline of around $40 billion for the developed countries, from a typical surplus of $10 billion or more to a deficit this year of close to $30 billion.

Such huge changes in payments positions will place obvious strains on the international financial system.

Three major problems may be distinguished:

(a) the effects of the huge accummulations of OPEC funds on the world's financial markets,

(b) the need to avoid a competitive scramble among the more industrially advanced countries (including some LDC's) to improve their current accounts at the expense of their neighbors, and

(c) the problem of financing of the needed oil imports of the LDC's without a substantial increase in their already heavy debt burden.

The first mentioned of these problems is much the least serious. The world's financial markets have considerable elasticity and should be able to absorb large quantities of OPEC funds without undue problems. While ownership of such large quantities of funds would give OPEC countries the potentiality of disrupting financial and exchange markets, they would have strong economic incentives not to do so.

The OPEC countries appear likely to invest a considerable portion of this initial accummulation of funds in the relatively more liquid portions of the Euro currency market. This further increase in the pool of internationally mobile funds heightens the need to avoid attempts at maintaining excessive exchange rate rigidity. At the same time, the Euro currency markets appear likely to play a quite useful intermediary role in rechanneling OPEC funds to countries needing to borrow to offset their increased oil payments. Given the access of most countries to the Euro currency markets, the need for special provisions to handle short-term financing problems may be largely limited to those poorer LDC's with low reserve positions and limited access to private international financial markets.

Probably more serious for the successful operation of the international economic system than the provision of funds for oil importing countries to borrow is the problem of assuring that they will borrow. Even under the most optimistic assumptions about reductions in oil prices* and increase in imports by the OPEC countries, overall balance of payments equilibrium between the OPEC countries and the rest of the world will require large capital flows from the OPEC countries to the rest of the world. While an individual country could match the higher import bill by an equal increase in exports, this option is just not available to the community of nations as a whole. Attempts by a substantial portion of individual countries to finance their higher import bills with increased exports would generate a largely self-defeating spiral of exchange rate depreciations against the OPEC nations and countries not entering into this export scramble.

While such a scramble, even if it occurred, would not necessarily generate a worldwide depression of the order of the 1930's, it would certainly imply several dislocations and costs to the international economy. Because of our lower dependence on international trade, the United States is probably in the best shape of any country to ride out such a stormy situation, despite the likelihood that the dollar would become one of the most "overvalued" currencies. All nations have a strong interest in avoiding such an outcome, however.

It should be noted that it is in the individual self-interest of most nations, as well as the community interest, for increased oil payments to be balanced in the short run by increased international borrowing. Exchange rate depreciation to offset oil payments would further bid up the domestic currency prices of oil and would further contribute to inflationary pressures.

*For instance, a reduction in government take from $7.00 to $5.00 per barrel for Saudi oil would cut the projected developed country current account deficit in half but would still leave an unprecedented deficit in the order of $15 billion.

Given the combination of the limited physical capacity of many of the OPEC countries to increase substantially their imports and the high degree of inelasticity of the short-run demand for oil, in the absence of large capital flows, the average exchange rate of oil importers vis-a-vis OPEC might have to depreciate by 50% or more to clear markets. The result could be a substantial reduction in the physical quantities of oil imported and a substantial further improvement in the terms of trade of OPEC vis-a-vis oil importers. While the reduced quantities of oil demanded could increase pressure on the cartel, a considerable price might be paid for this.

It should be noted that in an important sense the swing in current account balances which would be necessitated by maintenance of anything like the current structure of exchange rates would cause much smaller dislocations to the international economy than have much smaller shifts of current balances in the past. Under normal circumstances large changes in current account positions are resisted in part because of their short-run affects on production, employment, and the competitiveness of industries. The current large increase in the value of imports, however, is in a non-competitive product - oil. Much as increased banana imports do not put U. S. workers out of work, even in the short run, neither will increased oil imports have an adverse competitive effect on domestic producers. Thus, as long as appropriately expansionary macro-economic policies are followed, one of the normal reasons why some countries have in the past been concerned about changes in the structure of their balance of international payments does not apply to the current situation.

A second consideration, concern about a country's net international indebtedness, does, of course, continue to apply. For industrial countries it would seem a wise policy to allow some increase in indebtedness in the short run so as to minimize economic dislocations. Over the longer term, if current levels of price were maintained, many alternative forms of energy would become economic; and continued borrowing for several years could still be considered a transitional policy as progress was made toward reduced dependence on imported energy. [An alternative to this scenario, of course, would be a substantial lowering of OPEC prices in recognition of the long-run costs to the OPEC producers of spurring the development of alternative sources of energy. Despite the many scare stories of the worldwide energy shortage, the outlook for the future supply of fossil fuels is from a world perspective brighter today than it was twenty years ago. While basic market forces had been generating a tightening of the oil market during 1973, it is the contrived supply restrictions of the OPEC monopoly which has caused the current situation. From a long-run perspective, these costs may be borne as much or more by the OPEC countries as by oil importers, as alternative sources of energy are brought on stream and the demand for oil is reduced.]

Such an increase in borrowing is much less feasible for most LDC's. These countries are caught in a cruel bind. They tend to be even more dependent than Western Europe on oil as a source of energy and the lower degree of flexibility of their economies means that their industrial sectors would be particularly hard hit by reductions in oil imports. On the other hand, in the absence of special financing from other countries, many would not be able to pay for sufficient oil imports at current prices and even those who could secure financing would find themselves faced with undesirable increases in the level of their debt burdens. Clearly, to avoid a substantial deterioration in the standard of living in the poorest countries, the burden of present oil prices on these countries must be reduced. But the industrial countries are hardly in a position to increase their aid flows substantially. Thus, if such a worsening of the plight of the poorer countries is to be avoided, we must look to the OPEC countries. The industrial countries can play an important role in not further contributing to the situation in the LDC's however, by avoiding restrictions on both exports and imports and hence reducing the severity of the micro-economic dislocation which might otherwise be caused.

3. U. S. Guidelines for Floating Rates

The huge current account imbalances implied by current levels of oil prices are a structural problem which the U. S. proposals for floating cannot handle in their present stage of development. My guess would be that under "normal" situations the U. S. reserve based guidelines would be sufficient for a harmonious system and structural concerns could be handled by fairly loose principles against maintenance of "undervalued" currencies. The enormous size of the shift facing current payments positions, however, renders the U. S. proposals insufficient to handle the current situation, I fear.

This does not mean that the U. S. guidelines are not useful, nor that fixed rather than floating rates would be desirable now. (Indeed, I believe fixed rates at the current time would be disasterous.) What it does mean, however, is that the current U. S. proposed guidelines for floating rates would need to be supplemented in the short run by agreements for countries to undertake additional international borrowings in roughly the same size as their increased oil payments. This does not put a straight jacket on the useful role which floating rates can play but would "protect" countries against much larger declines in their current balances than would be induced by increased oil payments.

While such a supplementary agreement would be extremely useful, I believe it appears that it would be extremely difficult to make operational in the sense that reasonably clear-cut guidelines for "policing" of an agreement could be implemented.

A good deal of additional borrowing is likely to take place through private capital flows, either directly through OPEC country placements in importing countries or indirectly from OPEC to the Euro currency markets to borrowers in importing countries attracted by lowered Euro currency interest rates. Thus, requiring all importing countries to undertake government borrowings in the amount of increased oil bills would lead to "too high" a level of additional borrowings by countries in an toto.

What one might try to do would be to project average "normal" levels of total net private capital inflows based on past exercises and have governments take on an obligation to borrow in an amount equal to any shortfall of net private capital inflows below the total of the projected normal level plus increased oil payments.

Such an approach is, of course, much less than fully satisfactory. There would be considerable difficulty in making good projections, much less in obtaining international agreement on such projections. Furthermore, agreement on appropriate total levels of borrowings for the year could still leave a good deal of room for short-term "anti-social" manouvering.

Perhaps a more implementable approach would be to try to get government borrowing equal to some fairly high fraction of increased oil bills, despite the fact that this might lead to "overborrowing" by some countries. Clearly, however, some provision would have to be made to exempt from this countries which received quite large inflows of OPEC funds.

Indeed, for some countries, provisions would be required not only for reducing borrowing but also for allowing government re-export of capital. For instance, the U. S. could easily receive directly or indirectly $15 or $20 billion or more of additional capital inflows due to OPEC investments over the coming year. This would cause a much greater appreciation of the dollar than is likely to be tolerable politically. Thus, there might be strong reasons to encourage capital outflows, actions which would clearly be a beggar-thy-neighbor policy in the absence of extraordinary capital inflows.

Thus, I would conclude that probably the best we can do is to try to get agreement in principle that in the current situation merely floating freely is not sufficiently good international behavior, and hope that the deviations from this principle in practice will not be too serious. Even in the absence of objective operational guidelines, international review of countries' behavior in this regard in WP-3, the C-20, or the new IMF body would probably be worthwhile.

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Date:

Thus Twy ...

MEMORANDUM FOR. THE SECRETARY

THRU Under Secretary Solomon

From: Assistant Secretary Bergsten

Subject: Briefing for your Meeting with Ambassador to Saudi Arabia, John C. West

Date and Time: Tuesday, March 14, 1978 - 5:30 p.m.

Persons Expected to Attend:

Treasury Department	Secretary Blumenthal Under Secretary Solomon Assistant Secretary Bergsten Lewis W. Bowden, Deputy for Saudi Arabian Affairs
State Department	Ambassador West Joseph Twinam, Director, Arabian Peninsula Affairs

Recommended Recording Officer:

Bonnie Pounds, Director, Office of Saudi Arabian Affairs

I. Subjects which Ambassador West is expected to raise:

(a) Pricing of oil in basket of currencies other than the dollar. The Ambassador is interested in Treasury's assessment of the implications for the U.S. and Saudi Arabia if OPEC began pricing oil in the SDR or other basket of currencies.

Treasury Position: Treasury hopes that OPEC will not shift pricing of oil from the dollar to the SDR or other basket of currencies. You can tell Ambassador West that confidence in the dollar remains fragile. Recent and more frequent news reports regarding OPEC's growing disenchantment with use of dollar for oil pricing further disturb the market. If OPEC changed

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Initials/Date	BP/3/10	/	/	/	/	/

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the unit of accounting for oil pricing it could precipitate a major market reaction which would be in the interest neither of the Saudis, other OPEC members, nor the U.S.

Ambassador West should continue to stress to the Saudis the points made by you to Saudi Finance Minister Abalkhail in Paris in early February. A shift in the basis of oil pricing would not be a solution to the problem of the declining dollar for the following reasons:

Financial Markets:

(1) The U.S. provides the only markets capable of accommodating Saudi Arabia's large investment needs.

(2) Saudi Arabia already has a huge stake in U.S. capital markets. Any suspicion of a loss of Saudi confidence in the dollar could trigger a sell-off that would sharply reduce the capital value of existing Saudi assets.

(3) It is highly unlikely that other potential recipients of large investments would be prepared to accept the exchange rate consequences and would probably impose stringent capital controls. Even the Germans have made clear they do not want the DM to become a reserve currency.

SDR Basket

(1) No unit of account can provide full protection against exchange rate movements. The dollar value of the SDR has only recently returned to the mid-1975 level. If SDR pricing had been in effect during the past 2½ years, oil revenues would have been lower than with dollar pricing.

(2) A shift to the SDR would provide only a temporary respite from pressures within OPEC. Whenever the SDR's value declined, some OPEC members would seek changes in the pricing unit. In effect, the pricing unit would become a disguised mechanism for raising prices.

Background: Concern over the decline in the dollar has increased in recent weeks. The Kuwaitis and others have talked about calling an emergency OPEC meeting to discuss the decline of the dollar, pricing of oil in a basket of currencies, and an oil price hike to compensate OPEC for the decline in the dollar in foreign exchange markets. On March 7, Kuwaiti Finance Minister Ateeqi visited Saudi Arabia to discuss the continued decline in the dollar and the possibility of an oil price hike.

(b) U.S.-Saudi Joint Economic Commission

Ambassador West recently raised with Secretary Vance the importance of U.S.-Saudi cooperation. West recommended special attention be given by the Joint Economic Commission to producing projects with highly visible, tangible results.

State has asked that we take the occasion of this meeting to comment on the Ambassador's specific suggestions:

(1) That 5 to 10 high visibility projects be proposed to the Saudis this year; and

(2) That demonstration projects receive special priority in disbursing the first $500,000 available under the Solar Energy Agreement signed last October by you in Riyadh.

Talking Points

--Welcome Ambassador's interest in our Joint Commission program.

--Assure him we also want to maximize the Commission's utility in promoting our national goals in Saudi Arabia, such as continued Saudi production of sufficient quantities of oil at reasonable prices.

--At the same we should recognize there is little the Commission can do to offset possible Saudi disappointment over lack of a peace settlement in the Middle East or failure to sell them F-15 fighter aircraft.

(Please Note: This is a letter from Bruce Mathews, of Washington, D.C., representing Roger Tamraz.)

April 14, 1978

Mr. Roy D. Chapin
Chairman of the Board
American Motors Corporation
27777 Franklin Road
Southfield, Michigan 48034

Dear Roy:

It has been some time since we were together at the Newsweek Seminar in Florida and at the Gridiron Club affair in Washington. I have been hoping that our paths would cross long before now. Perhaps I shall have the opportunity to see you soon in connection with the idea set forth in this letter.

As I believe you know, I have been devoting most of my time in the past few years to working on projects in the Middle East. These projects involve the placing of Arab private sector capital in worthy U. S. investments and also involve the formation of joint ventures between U. S. companies and prominent Arabs to bring into being organizations which can bring U. S. technology and expertise into the various Arab countries in a fashion which will permit us to compete with the Europeans and the Japanese.

I have just learned that American Motors requires a revolving line of credit of $109 million for research and development and retooling. I have also noted that the traditional sources of commercial credit available to AMC have declined to provide this facility and that you have approached the U. S. Government to provide loan guarantees.

I am sure that you would agree that the happiest solution to AMC's problem would be one that involves the private sector rather than having to turn to the U. S. Government. It is with this in mind that I should like to set forth a proposal for your consideration.

In making this offer, we are representing The First Arabian Corporation a significant investment banking group based in Paris and operating throughout the Middle East and Europe. Within the past week, we have recommended to First Arabian that we explore with you the possibility of extending to you the credit you require combined with discussions as to how we might cooperate in the opening up of the lucrative Middle East market currently denied AMC due to your presence on the Arab Boycott List.

Mr. Roger Tamraz, Chairman of First Arabian, has authorized us to proceed with exploratory discussions which we should like to commence at the earliest possible date. We suggest the earliest possible date since we are aware that your Board is currently considering the various alternatives including the U. S. Government guarantee. We are also anxious to talk with you since Mr. Tamraz is planning a trip to the States in the next ten days and if we can reach a preliminary understanding, we can then ask Mr. Tamraz to meet with you to begin to finalize the arrangements.

My associate, Mr. Peter F. Schaefer, has had discussions with Congressman Les Aspin's office and has also contacted Mr. Secrest's office. Mr. Secrest's office suggested that we write a letter setting forth our proposal.

Roy, I want you to know that this is a serious proposal from what I consider to be the only group that is doing a professional job in representing Middle East investors. We have the capital to carry out the transaction and the capability to negotiate and manage a loan of this character. We also have the ability to assist in the opening up of the market in the Arab world to AMC and we believe, therefore, that this proposal is one that is far superior to any arrangement which AMC may be able to make with the U. S. Government.

For the record, I should like to say that we expect no fees or commissions from AMC since our total compensation will be paid by First Arabian Corporation.

I should appreciate hearing from you on Monday, if possible, to determine if you have an interest in exploring this idea. We shall be pleased to come to Southfield immediately thereafter and then to arrange a meeting with Roger Tamraz which could take place within ten days.

With warmest personal regards.

Sincerely,

Congress of the United States
Committee on Government Operations
House of Representatives

February 11, 1981

Hon. Donald T. Regan
Secretary
Department of the Treasury
Washington, D. C. 20220

Dear Mr. Secretary:

We are writing to you in your capacity as Chairman of the Interagency Committee on Foreign Investment in the U.S. (CFIUS), to request that the Committee meet and examine the hostile takeover attempt of Hobart Corporation of Troy, Ohio, by Canadian Pacific Enterprises Ltd. and its wholly-owned American subsidiary, Canadian Pacific Enterprises (U.S.) Inc.

Under Executive Order 11858, as amended, CFIUS has primary responsibility within the Executive Branch for monitoring the impact of foreign investment in the United States and for coordinating the implementation of U.S. policy with respect to such investment. To fulfill this responsibility, the Committee is required to:

> "review investments in the United States which, in the judgment of the Committee, might have major implications for United States national interest;..."

In August 1980, the Committee on Government Operations issued a report, based on a study by this subcommittee, entitled "The Adequacy of the Federal Response to Foreign Investment in the U.S." A portion of that report was devoted to CFIUS and found that CFIUS had completely failed to carry out the mandates of the Executive Order. As a result, the report recommended that CFIUS function more actively, meet more regularly, make all decisions as a collegial body (with no matters screened out), and that private investments no longer be effectively excluded from CFIUS review.

Our urgent request that you convene the Committee, which is consistent with the report's recommendations, is based on the likelihood that this proposed acquisition will have severe negative implications for U.S. national interests, not only in the State of Ohio, but also for the entire U.S. economy.

Hobart Corporation is based in Troy, Ohio, and was founded in 1897. It produces under the trademark "Kitchen-aid" and "Hobart" top-of-the-line food equipment and kitchen appliances, such as dishwashers, food mixers, ovens, refrigerators, and food packaging equipment, for both home and commercial use. In addition to its 24 plants in the United States, it has 12 plants abroad and a sales organization which supports marketing operations in 100 countries. It employs 9,000 persons in the United States and 4,000 persons abroad. In 1979 its net sales totaled $630 million.

First, as we understand, Canadian Pacific has given no assurances that it would continue to operate Hobart's U.S. plants on a long-term basis. In fact, Canadian Pacific's U.S. subsidiary's staff have advised Ohio State securities authorities that some Hobart plants would be closed. In Troy, Ohio, alone, Hobart employs over 2,000 persons. Nationally, it employs 9,000 persons. Further, Canadian Pacific has given no assurances that it would not transfer out of the U.S. to Canada some of the technology which has made Hobart's products high quality ones.

Second, through its extensive overseas activities, including a sales-and-service organization which supports marketing operations in 100 countries, and 12 plants abroad, Hobart consistently earns and repatriates profits to the United States. For example, in 1979 Hobart grossed $173.4 million in sales abroad. These earnings have contributed favorably to the U.S. balance of payments. If Hobart is acquired by Canadian Pacific, it is likely that the bulk of these foreign earnings will go into Canada and represent a net outflow of capital.

Third, two U.S. banks and three Canadian banks will lend Canadian Pacific $400 million to acquire Hobart. Very little foreign equity or venture capital will be utilized (probably around $28 million). Most of the funds slated to come into the United States for this acquisition will have to be paid back, primarily from Hobart's future U.S. earnings. Net inflows of capital over the long run will be minimal, if they materialize at all. It is thus very questionable that this proposed transaction would benefit the U.S. balance of payments, a factor most often cited for the U.S. policy of "neutrality with encouragement." In reality, the repayment of those loans to Canadian banks by C.P.'s U.S. subsidiary and the payment of interest on them, together with the repatriation of profits, will probably hurt the U.S. balance of payments.

Fourth, closely related, the two American banks, Chemical Bank of New York and Lincoln First National Bank of Rochester(New York) have agreed to lend Canadian Pacific approximately $75 million. The use of borrowed money to finance the acquisition of a company directly contravenes Federal Reserve policy.

Fifth, the proposed acquisition has negative anticompetitive implications because many of Hobart's customers compete with Canadian Pacific. These customer/competitors -- hotels and air and steamship lines -- depend upon Hobart for commercial kitchen equipment. If the acquisition occurs, their independent source of supply may be terminated. Whether the U.S. antitrust laws can be effectively applied to prevent this needs to be examined.

Accordingly, we hereby request that you convene CFIUS as soon as possible because of the imminency of this acquisition. We ask further that, as provided in CFIUS' June 1978 guidelines, a Federal Reserve official be asked to participate, in view of the possible violation of Fed policy. If Canadian Pacific refuses to delay its tender offer in order to allow CFIUS to fully consider this proposed acquisition, we would request that you consult with the Canadian Government, as is CFIUS' stated practice, to request their intervention in delaying the acquisition. If the acquisition is not delayed, we would request that CFIUS consult with, and make recommendations to, the Economic Policy Group and the National Security Council, requesting their immediate intervention, as the Executive Order and the CFIUS guidelines provide.

We are hopeful that CFIUS will thoroughly and immediately consider all implications of this proposed acquisition and that it will hold discussions with both Canadian Pacific and Hobart to determine whether or not the proposed acquisition does have negative implications for U.S. national interests. A complete report of CFIUS' activities in this regard would be appreciated.

A copy of this letter is being sent to the other members of CFIUS and also to the Chairman of the Federal Reserve Board and the Justice Department.

Sincerely,

Benjamin S. Rosenthal
Chairman
Subcommittee on Commerce,
Consumer, and Monetary Affairs

Lyle Williams
Ranking Minority Member
Subcommittee on Commerce,
Consumer, and Monetary Affairs

cc: Secretary of State
Secretary of Commerce
Secretary of Defense
U.S. Trade Representative
Chairman, Council of Economic Advisers
Chairman, Board of Governors, Federal Reserve System
Assistant Attorney General, Antitrust Division

BSR:mb

ASSISTANT SECRETARY

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

March 10, 1981

Dear Mr. Chairman:

This is in reply to your letter of February 11, in which you requested that the Committee on Foreign Investment in the United States (CFIUS) review the proposed investment by the United States subsidiary of the Canadian Pacific Enterprises Ltd. in Hobart Corporation.

The Committee on Foreign Investment in the United States (CFIUS), and, in particular, the Office of Foreign Investment in the United States (OFIUS), continuously monitor foreign investment in the United States. The Administration is therefore aware of the developments in this case.

The United States has a critical need at this time for additional investment to increase economic growth, to provide new jobs, and to improve productivity. Foreign investment, when it responds to market forces, provides many of the same benefits associated with domestic investment and thus has a role to play in helping the nation achieve these economic goals.

In recognition of this need for investment, the Administration's economic policy, as outlined by President Reagan on February 18, has as one of its primary goals the removal of impediments to the flow of private investment. Specifically, the Administration seeks to reduce unnecessary Federal government intervention in private investment decisions, foreign and domestic. All investors, foreign and domestic, must comply, however, with Federal, state and local regulations relating to investment; and government regulatory agencies such as the SEC and the Justice Department do act to assure such compliance.

You are correct in asserting that the CFIUS has the responsibility for reviewing foreign "investments in the United States which might have major implications for United States national interests." There are, however, only a few private investments which do have major implications for the national interest.

The CFIUS is aware of Congressional, company and public interest in this case, and will continue to follow developments in this case, as it does for all sizeable foreign investments in the United States. However, it is not apparent that the proposed takeover has major implications for U.S. national interests, and therefore a CFIUS review is not required.

We note also that recently a U.S. firm has apparently reached a merger agreement more acceptable to the present management of Hobart Corporation.

A separate reply is being sent to Mr. Williams.

Sincerely,

(Signed)

W. Dennis Thomas
Assistant Secretary
for Legislative Affairs

The Honorable
Benjamin S. Rosenthal
Chairman
Subcommittee on Commerce,
Consumer, and Monetary Affairs
House of Representatives
Washington, D.C. 20515

TREASURY DEPARTMENT

Document No. F-22

Spring 1977

TALKING POINTS ON WITTEVEEN PROPOSAL FOR IMF SUPPLEMENTARY CREDITS -- FOR TREASURY'S USE WITH A HIGH LEVEL OFFICIAL OF A MIDDLE EAST OPEC COUNTRY

1. The US and the Middle East OPEC country are in a position jointly to provide leadership in a matter of major importance to the world economic and financial order -- the establishment of a much needed reinforcement to the international monetary system.

2. We have given careful consideration to Witteveen's proposal for IMF Supplementary Credit. We think it sensible, realistic, and necessary. Among its advantages are the following:

a) It would represent a cooperative endeavor between the oil producing nations and the industrial nations -- in contrast to other financing proposals which are more exclusive (or even confrontational) between the two groups.

b) It will promote confidence in the international monetary and banking system, thereby greatly strengthening the system to the benefit of all nations including those with large financial claims.

c) It will promote economic stabilization and adjustment on the part of borrowing nations, reducing their financing needs and improving their creditworthiness, and fostering a sustainable pattern of international payments.

d) It will be good investment for the lenders, not only in terms of their stake in a strong and smoothly functioning world monetary system, but also in a strict financial sense. Specifically:

- -- asset would be very secure with IMF backing;
- -- asset itself is "diversified" and its value is not dependent on developments in any one country;
- -- would have market-related interest rates; and
- -- would be highly liquid reserve asset. [Note. These loans will be included in the "IMF reserve position" of lenders. U.S. & other G-10 countries include "IMF reserve position" as part of their own reserve statistics].

e) It is worldwide in coverage, in terms of lenders as well as eligible borrowers, recognizing the interdependence of developed, developing, oil producing, and industrial creditor countries.

f) It will help meet the direct financing needs of the developing countries, as well as the middle income and other nations with serious financing needs. Moreover, it will be of great indirect value to the developing countries since it will contribute strongly to a healthy and growing world economy with increasing levels of international trade. All countries would lose if there were moves toward excessive deflation, controls on trade and capital flows, and other protectionist measures.

[Note: If the officials of the Middle East OPEC country argue that their credits must be earmarked for DLcs, the response is:

i) Such an arrangement would be discriminatory and contrary to the IMF Articles. Uniformity of treatment is basic to the IMF.

ii) Any earmarking would lead to pressures for earmarking by all countries, and to strong political and other pressures to restore the Financial Support Fund. (FYI. GAB is available only to GAB participants -- but that arrangement did not expand any member's access to IMF resources; rather it helped the IMF to meet eligible claims on its resources indirectly by any country. The IMF oil facility -- which did expand access -- was open to all members on a uniform basis).

iii) Major potential industrial borrowers -- two Western European countries -- have only recently received substantial IMF funding. (FYI. Do not promise that these countries will not borrow from Witteveen facility. One of them is a very live candidate)].

3. In light of these advantages, the United States strongly supports the proposed Supplementary Credit and is prepared to agree to substantial United States participation provided that there is an assurance of adequate participation on the part of the Middle East OPEC country and others.

4. To be effective, the Supplementary Credit should in our view, have the key features listed below.

a) Size - Witteveen's target of a total amount of SDR 14 billion ($16 billion) looks reasonable. An initial amount of SDR 9-10 billion fully committed is essential (See Tab A for shares of the Middle East OPEC country and other countries.

-- Necessary to provide confidence in monetary system and creditibility of facility.

— Looks negotiable.

-- Facility must be big enough to enable U.S. and others to drop alternative proposals.

Consideration could be given to phasing in additional amount at later stages but for above reasons the initial facility should be minimum of $9 billion SDR's (about 10.5 billion dollars).

b) Sharing - 50/50 of lending between OPEC and industrial countries.

-- Shows both groups are sharing responsibility for reinforcing monetary system.

-- Provides maximum confidence for system.

-- Is equitable in terms of financing capabilities.

-- Makes OPEC a full partner in maintenance of a viable monetary system.

-- Important political factor in gaining legislative approval in U.S. and elsewhere.

c) Availability - Uniform basis to all IMF members, developing and developed alike, since we face a system-wide problem which calls for a system-wide solution.

d) Conditionality - Should have reasonable requirements for conditionality.

-- Insistence on conditionality does not mean that we assume oil surpluses can be substantially reduced in short-run, but rather that counterpart deficits will be redistributed among countries with greater capability to borrow and incur debt.

-- IMF's record in enforcing conditionality is good; not so soft as to be meaningless nor so harsh as to be politically unacceptable.

e) IMF borrowing from BIS or market - Should not be considered at present.

-- Technique is untested, and technically complicated, could take long time to work out, with results uncertain.

f) Interest rates - Should be market-related.

Tab A

	SDR Billion		
	Initial Witteveen Proposal	Suggested Minimum Package**	
		Amount	% Area Total
Industrial Countries			
U.S.	2.5	1.6	(35.6)
Germany	2.0	1.2	(26.7)
Japan	1.2 [1.4]*	0.8	(17.7)
Switzerland	0.9-1.0	0.6	(13.3)
Netherlands	0.3	0.2	(4.4)
Belgium	0.1-0.2	0.1	(2.2)
	7.0-7.2 [7.4]*	4.5	(100.0)
OPEC Countries			
Saudi Arabia	4.0	2.5	(55.6)
Kuwait	2.0	} 1.0	(22.2)
UAE, etc.	0.3		
Iran	0.7-0.8	0.5	(11.1)
Venezuela	(0.5)*	0.5	(11.1)
	7.0-7.1 [7.6]*	4.5	(100.0)
	14.0-14.3 [15.0]*	9.0	

* For Japan, Witteveen first spoke of SDR 1.2 billion, but actually requested SDR 1.4 billion. For Venezuela, no amount was specifically mentioned by Witteveen, but GOV offered SDR 500 million.

** Minimum Package -- Witteveen's original proposal, scaled down to SDR 9 billion in rough proportion.

APPENDIX 11.—FEDERAL HOME LOAN BANK BOARD (FHLBB) AND FEDERAL HOME LOAN MORTGAGE CORPORATION (FHLMC) AND OTHER FOREIGN DOCUMENTS RELATING TO OPEC AND OTHER FOREIGN INVESTMENT IN THEIR DEBT SECURITIES

A. MATERIAL RELATING FOREIGN OWNERSHIP OF FEDERAL NATIONAL MORTGAGE ASSOCIATION AND FARM CREDIT ADMINISTRATION DEBT SECURITIES AND PROMOTIONAL SALES EFFORTS

.s & Co. | 55 Broad Street | New York, New York 10004
.5-8349

Daniel W. Hofgren
Vice President
Corporate Finance Department

Goldman
Sachs

July 25, 1978

Mr. Charles Meyers
Deputy Director Office
of Finance
Federal Home Loan Bank
1700 G Street, N.W.
Washington D. C. 20552

Dear Charlie:

I am writing you pursuant to our discussions over the past few months about the advisability of the Federal Home Loan Bank Board and FHLMC making a presentation to European investors.

As I have discussed with you, the growth of the Eurodollar market has grown to where it now approximates $400 billion. This market offers an opportunity for your organization to sell your notes and debentures on a regular basis. It is conservatively estimated that foreign holders of agency paper totals somewhere between 10-20% of all outstandings. This includes the three major agencies, i.e., Federal National Mortgage Association, Federal Home Loan Bank and the Farm Credit Administration. In view of your long term needs, it appears to us that this market should not be ignored.

About five years ago, we took the opportunity of introducing FNMA to this market. In so doing, we arranged for the Chairman, A. Oakley Hunter, the Executive Vice President, Robert Bennett, and John O'Mara, a Director, to visit London, Paris, Frankfurt and Zurich. The visits were approximately one day long and included a luncheon and dinner with top institutional investors in these cities. Their presentation was no different than those which they have given in the United States from time to time. The importance of this was that the institutions started to obtain a clearer view of the functions of FNMA and its various instruments.

We have followed these visits up on a yearly basis and we have been successful in enlisting support from these European institutions in purchasing FNMA's paper. Specifically, as of this past year we have obtained an offer for a private placement with a yield to the investor equal to that of the United States. This is the first time that opportunity has arisen and is presently before the Treasury Department for consideration.

Goldman
Sachs

Mr. Charles Meyers
July 25, 1978
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Our proposal would be that yourself and either the Chairman or Mr. Marston make a similar visit within the next eight weeks in order to introduce the Federal Home Loan Bank Board. We also feel that it would be important for Phil Brinkerhoff and the Mortgage (FHLMC) Corp. to be included.

As I explained to you on the telephone, we have just completed a trip for FNMA in June. We visited four cities; London, Frankfurt, Zurich and Paris. I am attaching for your information a list of the institutions which attended the sessions.

It was the opinion of FNMA and of ourselves that this was the most successful of our six visits. More institutions expressed an interest in attending and the quality of their questions reflected their interest.

In closing I might add that the Farm Credit Agency makes a visit once a year as well as FNMA and, therefore, it is certainly appropriate now for you to be exposed to this very large and important market.

With warm regards,

Sincerely,

Daniel W. Hofgren

DWH:sh

February 10, 1978

Mr. Phil Brinkerhoff
President
Federal Home Loan Mortgage Corporation
311 First Street, N.W.
Washington, D.C. 20001

Dear Phil:

I am writing you pursuant to our discussions over the past few months about the advisability of FHLMC making a presentation to European investors.

As I have discussed with you, the growth of the Eurodollar market has grown to where it now approximates $400 billion. This market offers an opportunity for your organization to sell your notes and debentures on a regular basis. It is conservatively estimated that foreign holders of agency paper totals somewhere between 10-20% of all outstandings. This includes the three major agencies, i.e., Federal National Mortgage Association, Federal Home Loan Bank and the Farm Credit Administration. In view of your long term needs, it appears to us that this market should not be ignored.

About five years ago, we took the opportunity of introducing FNMA to this market. In so doing, we arranged for the Chairman, A. Oakley Hunter, the Executive Vice President, Robert Bennett, to visit London, Frankfurt and Zurich. The visits were approximately one day long and included a luncheon and dinner with top institutional investors in these cities. Their presentation was no different than those which they have given in the United States from time to time. The importance of this was that the institutions started to obtain a clearer view of the functions of FNMA and its various instruments.

We have followed these visits up on a yearly basis and we have been successful in enlisting support from these European institutions in purchasing FNMA's paper. Specifically, as of this past year we have obtained an offer for a

Mr. Phil Brinkerhoff
February 10, 1978
Page 2

private placement with a yield to the investor equal to that of the United States. This is the first time that opportunity has arisen and is presently before the Treasury Department for consideration.

Our proposal is for you and someone from the Board to make a similar visit within the next eight weeks in order to introduce FHLMC as well as the Federal Home Loan Bank Board to these institutions. Such a trip will take a minimum of 3-4 days. Our organization, with any others whom you may recommend, will make all the arrangements and invite the institutional investors, similar to the way you do it in the United States.

In closing I might add that the Farm Credit Agency makes a visit once a year as well as FNMA and, therefore, it is certainly appropriate now for you to be exposed to this very large and important market.

With warm regards,

Sincerely,

Daniel W. Hofgren

DWH:ag

Goldman
Sachs

Names of people who attended the London FNMA Luncheon
on June 23, 1978:

John Whitehead	Barclays Unicorn
Ann Busby	De Zoete & Bevan
Martin Beaver	John Govett & Co.
Len Strange	Guinnes Mahon
Peter Andreae	Kleinwort Benson
Martin Ashworth	Mercantile & General
David Dobbs	Morgan Grenfell
Graham Bishop	Phillips & Drew
Paul Stafford	Provident Mutual
Dick Deslandes	Prudential
Madelaine Gore	Rothschilds
Consuelo Brooke	S. G. Warburg & Co.
Paul Armstrong	Hambros
Gert Reiff	Schroder Wagg
Alan Wrigley	Lazards
Edward Pelentrides	Crown Agents
Guy Stokley	Manufacturers Life

Re: Federal National Mortgage Association
- Prsentation on June 26, 1978 at 7:30 p.m.,
19th Floor of Deutsche Bank -

Participants:

FNMA	Mr. Allan Oakley Hunter Chairman of the Board and President
	Mr. Robert Bennett Executive Vice President and Chief Financial Officer
	Mr. John M. O'Mara Director FNMA and First Vice President White, Weld & Co.
	Mrs. E. Warwick Assistant to the Management
Goldman Sachs	Mr. Paul Goldschmidt Director, London
	Mr. Daniel W. Hofgren Vice President, New York
	Mr. Jim Baker Vice President and Associate Manager, Zurich
Deutsche Bank	Dr. Peter Grasnick First Senior Vice President Corporate Finance Department
	Mr. Michael von Brentano First Senior Vice President Corporate Finance Department

Deutsche Bank, continued	Mr. Jochem Bessler Senior Vice President Trading Department
	Ms. Gisela Kurtz Senior Vice President Economic Department
	Dr. Siegfried Weber Vice President Corporate Finance Department
	Mr. Günter Hammann Corporate Finance Department
ADIG	Dr. Kaposi
Bayerische Hypotheken- und Wechsel-Bank	Mr. Wetzel
Bayerische Vereinsbank	Dr. Humbert
BHF-Bank	Mr. Aulbach
Commerzbank	Mr. Neumayer
Richard Daus & Co. Bankiers	Mr. Thiemann
Deutsche Gesellschaft für Anlageberatung mbH (DEGAB)	Ms. Ostermeier
Deutsche Gesellschaft für Fonsverwaltung mbH (DEGEF)	Dr. Baltzer
Deutsche Gesellschaft für Wertpapier-sparen mbH (DWS)	Mr. Bohm
Deutsche Girozentrale - Deutsche Kommunalbank	Mr. Diver
DG-Bank	Mr. Poulev
Dresdner Bank AG	Mr. Heischmann

dresdnerbank investment management Kapital-anlagegesellschaft mbH	Mr. Greiner
Effectenbank-Warburg AG	Mr. Fehring
Hessische Landesbank - Girozentrale	Mr. Eissing
Bankhaus Merck, Finck & Co.	Mr. von Salza
Bankhaus B. Metzler seel. Sohn & Co.	Mr. Keller
Harald Quandt Erben mbH	Mr. Schumann
Bankhaus Sal. Oppenheim jr. & Cie.	Mr. Rössinger
Bankhaus Schröder, Münch-meyer, Hengst & Co.	Mr. Kraus

In addition, the following houses were invited, which, however declined the invitation or did not respond:

Bank für Gemeinwirtschaft	(declined)
Bayerische Landesbank Girozentrale	(declined)
Hauck & Sohn	(declined)
Westdeutsche Landesbank Girozentrale	(no response)

Federal Natl Mtge Luncheon

Ritz Hotel, Paris 28th June '78

Mr. Francois Chevalier	Banque de l'Union Europeenne
Mr. Jean Loup Chenut	La Paternelle
Mr. Alain Colaz	Morgan Guaranty
Mr. Roger Cruise	Banque de Neuflize
Miss Geistodt-Kienrer	Societe Generale
Mr. Jean-Louis Decroix	Compagnie Financiere de Suez
Mr. Dominique Eugene X	Banque Generale du Phenix =16
Mr. Pierre Carrus	Banque Worms
Mr. Arnaud Clement Grandcourt	Credit du Nord
Ms. Beatrice Philippe	Pan Holding
Mr. Marcel Dubois	Mutuelle Industrielle
Mr. Morelieras	Banque Jordaan
Mr. Alain de Lorgeril	Banco de Bilbao
Ms. Helene de Luze	Banque Industrielle Mobiliere P
Mr. Langer	La Concorde

Names and addresses of people who will attend the presentation and luncheon at the Hotel Baur au Lac on June 27, 1978:

Ms. Katherine Klaingüti
Mr. Reinach Mayer
Manufacturers Hanover
Trust Co.
Stockerstrasse 33
8002 Zurich

Mr. Ernst Zbinden
Swiss Credit Bank
P.O. Box
8021 Zurich

Mr. Rolf Klein
Schweiz. Hypotheken und
Handelsbank
Löwenstrasse 62
8023 Zurich

Mr. Jean-Paul Kimche
Banque Uto
Beethovenstrasse 24
8002 Zurich

Mr. Albert Gowen
Bankers Trust AG
Dreikönigsstrasse 6
8022 Zurich

Mr. Hans Kaufmann
Zürcher Kantonalbank
Bahnhofstrasse 9
8001 Zurich

Dr. Roland Hartmann
Standard Chartered Bank AG
Bleicherweg 62
8002 Zurich

Mr. Alfred Post
Swiss Volksbank
Bahnhofstrasse 53
8021 Zurich

Mr. Heinz Feurer
Banque de Gestion Financière
Gartenstrasse 26
8039 Zurich

Mr. Willy Weber
Rothschild Bank AG
Zollikerstrasse 181
8034 Zurich

Mr. Markus Iseli
Union Bank of Switzerland
Bahnhofstrasse 45
8021 Zurich

Mr. Franz Schneider
Finanz & Wirtschaft AG
Bäckerstrasse 7
8004 Zurich

Mr. Max Vollenweider
Julius Baer & Co.
Bahnhofstrasse 36
8022 Zurich

Mr. Albert Pauchard
Handelsbank N.W.
Talstrasse 59
8001 Zurich

Mr. Kurt Gubler
Matuschka & Partner
P.O. Box 406
8027 Zurich

Mr. M. Siebmann
Zurich Insurance
Mythenquai 2
P.O. Box
8022 Zurich

Dr. Martin Ebner
Bank Vontobel
Bahnhofstrasse 3
8001 Zurich

Mr. Josef Graber
Swiss Bank Corporation
Paradeplatz 6
8022 Zurich

Mr. Juerg Heberlein
Lehndorff Vermögensverwaltung AG
Rämistrasse 5
8001 Zurich

Mr. Walter Herdener
Ufitec SA
Talstrasse 65
8001 Zurich

Mr. Georg von Richter
Clariden Bank
Claridenstrasse 35
8002 Zurich

Mr. Eric Franck
Privat Kredit Bank
Tödistrasse 47
8022 Zurich

Dr. Mario Corti
Swiss National Bank
Börsenstrasse 15
8001 Zurich

Mr. Alfred Schenk
Ueberseebank AG
Limmatquai 2
8024 Zurich

Dr. Gerhard Landert
Weinmanngasse 88
8700 Küsnacht

Mr. Walter Hofmann
Société Générale Alsacienne
de Banque
Bleicherweg 1
8001 Zurich

Dr. Eric Gasser
Mr. Bruno Schmidt
J. Henry Schroder Bank AG
Central 2
8001 Zurich

Rec'd. Wed. night after 5:15 pm 10/18/78

·1713 EDT

381183708LGEN G
16TH OCTOBER 1978 - 2214

GBL 832

TO: FEDERAL HOME LOANS BANK,
WASHINGTON DC,

ATTENTION: CHARLES G. MYERS,
DEPUTY DIRECTOR,
OFFICE OF FINANCE.

FOLLOWING OUR RECENT TELEPHONE CONVERSATIONS WE SET OUT BELOW THE FRAMEWORK FOR THE PRIVATE PLACEMENT PROPOSITION WHICH WE HAVE DISCUSSED AND WHICH, FOLLOWIN YOUR REVIEW, WE WOULD LIKE TO SUBMIT TO [redacted]. AS YOU WILL SEE, THE FRAMEWORK IS AT A FIRST DRAFT STAGE AND WE WOULD BE MOST GRATEFUL FOR YOUR INPUT ON CERTAIN MATTERS, PARTICULARLY IN RELATION TO THE PRECISE EXPLANATION OF YOUR REASONS FOR UNDERTAKING THE TRANSACTION AND THE POSITION REGARDING GOVERNMENTAL CONSENTS.

THE FOLLOWING POINTS SHOULD BE BORNE IN MIND IN RELATION TO THE DRAFT:-

1) YOUR CONCERN THAT SECURITIES MIGHT FLOW BACK INTO THE UNITED STATES IS A PARTICULARLY DIFFICULT POINT TO DEAL WITH. AS YOU KNOW, [redacted] INTENTION WHEN IT MAKES AN INVESTMENT OF THIS TYPE IS TO HOLD THE SECURITIES ISSUED UNTIL MATURITY. FROM THEIR POINT OF VIEW THERE IS, THEREFORE, NO FLOW BACK PROBLEM AND TO SUGGEST THAT THERE MIGHT BE WOULD BE TANTAMOUNT TO DOUBTING THEIR WORD. WE DO, HOWEVER, RECOGNISE THAT, IN VIEW OF THE INTEREST RATE PREMIUM WHICH YOU ARE WILLING TO PAY, YOU SHOULD HAVE SOME COMFORT ON THIS MATTER. WE HAVE THEREFORE PROVIDED THAT THE SECURITIES TO BE ISSUED WOULD BE IN THE FORM OF REGISTERED NOTES OF HIGH DENOMINATIONS AND THAT THE FEDERAL RESERVE BANK OF NEW YORK WOULD MAINTAIN THE REGISTER OF HOLDERS AND ACT AS CUSTODIAN OF THE NOTES FOR [redacted]. ON THIS BASIS, IN THE UNLIKELY EVENT THAT [redacted] WAS TO DISPOSE OFTHE NOTES PRIOR TO MATURITY, YOU WOULD REQUIRE TO BE NOTIFIED THAT SUCH A SALE HAD TAKEN PLACE. ALTHOUGH, AS YOU WILL APPRECIATE, THIS WOULD NOT PRECLUDE A FLOW-BACK SITUATION OCCURRING, IT WOULD ENABLE YOU TO MONITOR THE SITUATION. WE THINK IT UNLIKELY THAT [redacted] WOULD BE PREPARED TO STRUCTURE THE TRANSACTION ON A LOAN BASIS AS THIS WOULD BE CONTRARY TO THEIR BASIC PHILOSOPHY THAT TRANSACTIONS OF THIS TYPE ARE AN INVESTMENT IN SECURITIES. SO FAR AS WE ARE AWARE, THERE IS NO PRECEDENT OF A TRANSACTION WITH [redacted] BEING ARRANGED AS A LOAN.

2) AS I THINK I HAVE ALREADY MENTIONED TO YOU, IN VIEW OF COMMENTS WHICH WERE MADE TO ME WHEN I WAS IN [redacted] LAST WEEK, WE BELIEVE IT TO BE IMPORTANT THAT THE FEDERAL RESERVE BOARD AND THE TREASURY ARE AWARE THAT THE SINGLE LENDER REFERRED TO IN THE FRAMEWORK IS [redacted]

[Note: Name of Middle East OPEC Government agency deleted by F.H.L.B. Board.]

3) WE HAVE INCLUDED TWO PARAGRAPHS IN THE FRAMEWORK IN WHICH WE HAVE ATTEMPTED TO SET OUT YOUR RATIONALE FOR ENTERING INTO A TRANSACTION OF THIS TYPE. IF THESE DO NOT ACCURATELY REFLECT YOUR MOTIVES PLEASE AMEND AS YOU THINK APPROPRIATE.

4) IN THE SECTION ON GOVERNMENTAL CONSENTS, WE HAVE TRIED TO SET OUT WHAT WE FEEL WOULD BE THE IDEAL POSITION TO REPORT TO [redacted] AT THIS STAGE. PLEASE FEEL FREE TO AMEND HOWEVER AS YOU THINK FIT.

5) DURING THE PAST WEEK WE HAVE OBTAINED AND REVIEWED THE DOCUMENTATION WHICH HAS BEEN UTILISED BY TWO US CORPORATIONS WHICH HAVE UNDERTAKEN PRIVATE PLACEMENTS WITH [redacted] DURING 1978. WE NOTE THAT THE ROUTE WHICH HAS BEEN ADOPTED IN ORDER TO ENSURE THAT PAYMENTS OF INTEREST MAY BE MADE GROSS IS AS WE OUTLINED IN OUR LETTER TO YOU OF 23RD JUNE - VIZ RELIANCE UPON SECTION 894 OF THE INTERNAL REVENUE CODE OF 1954.

6) YOU WILL NOTE THAT WE HAVE SPECIFIED A MATURITY OF TWO YEARS. PLEASE LET US KNOW IF THIS DOES NOT MEET YOUR REQUIREMENTS.

START

FRAMEWORK OF A PRIVATE PLACEMENT PROPOSAL
FOR THE
FEDERAL HOME LOANS BANKS

THE FEDERAL HOME LOAN BANKS

THE FEDERAL HOME LOAN BANK SYSTEM CONSISTS OF TWELVE DISTRICT FEDERAL HOME LOAN BANKS TOGETHER WITH THEIR MEMBER INSTITUTIONS. THE SYSTEM IS DESIGNED TO PROMOTE HOME OWNERSHIP THROUGH THE EXTENSION OF CREDIT TO SAVINGS AND HOME FINANCING INSTITUTIONS. MEMBER INSTITUTIONS INCLUDE ALL FEDERALLY CHARTERED SAVINGS AND LOAN ASSOCIATIONS, AND MEMBERSHIP IS AVAILABLE TO OTHER QUALIFIED INSTITUTIONS, SUCH AS STATE-CHARTERED SAVINGS ASSOCIATIONS AND MUTUAL SAVINGS BANKS. THE FEDERAL HOME LOAN BANK SYSTEM IS GOVERNED AND REGULATED BY THE FEDERAL HOME LOAN BANK BOARD, WHICH IS AN INDEPENDENT FEDERAL AGENCY ~~IN THE EXECUTIVE BRANCH~~ OF THE UNITED STATES GOVERNMENT.

THE FEDERAL HOME LOAN BANKS ARE INSTRUMENTALITIES OF THE FEDERAL GOVERNMENT AND ARE OWNED BY AND SERVE AS CENTRAL CREDIT BANKS FOR MEMBER INSTITUTIONS. THEIR PRINCIPAL SOURCE OF FUNDS IS THE ISSUE OF PUBLIC DEBT INSTRUMENTS ('CONSOLIDATED OBLIGATIONS') WHICH ARE THE JOINT AND SEVERAL OBLIGATIONS OF ALL THE FEDERAL HOME LOAN BANKS.

THE CONSOLIDATED OBLIGATIONS OF THE FEDERAL HOME LOAN BANK SYSTEM ARE SECURED BY THE COMBINED ASSETS OF THE TWELVE FEDERAL HOME LOAN BANKS ~~AND INDIRECTLY BY THE ASSETS OF THE SAVINGS AND LOANS AND SAVINGS BANKS THAT ARE MEMBERS OF THE SYSTEM.~~

PARAMETERS OF THE PRIVATE PLACEMENT

THE BASIC TERMS ON WHICH THE FEDERAL HOME LOAN BANKS ARE INTERESTED IN ARRANGING A PRIVATE PLACEMENT ARE AS FOLLOWS:-

BORROWER:	FEDERAL HOME LOAN BANK SYSTEM
TYPE OF OPERATION:	A WHOLLY PRIVATE PLACEMENT OF NOTES WITH NO PUBLICITY AND WITH ONE LENDER
AMOUNT:	UP TO U.S. DOLLARS 300 MILLION
MATURITY:	1—2 YEARS
AMORTISATION:	NONE
INTEREST RATE:	0.05 0/0 PER ANNUM ABOVE THE YIELDS IN THE U.S. DOMESTIC SECONDARY MARKET ON OUTSTANDING FEDERAL HOME LOAN BANK SYSTEM OBLIGATIONS OF A COMPARABLE MATURITY
ISSUE PRICE:	100 0/0
STATUS OF THE NOTES:	WOULD RANK PARI PASSU IN POINT OF SECURITY WITH THE EXISTING CONSOLIDATED OBLIGATIONS OF THE BORROWER
DENOMINATION OF THE NOTES:	NOT LESS THAN U.S. DOLLARS 5 MILLION EACH
DRAWDOWN:	IN FULL UPON COMPLETION OF THE DOCUMENTATION

THE BORROWER'S RATIONALE FOR ENTERIN INTO A PRIVATE PLACEMENT WITH THE PROPOSED LENDER ON THE ABOVE TERMS

(A) THE PROPOSED LENDER HAS IN THE PAST PURCHASED SECURITIES WHICH HAVE BEEN PUBLICLY ISSUED BY THE BORROWER IN THE UNITED STATES DOMESTIC MARKET. THE BORROWER DOES, HOWEVER, WISH TO ESTABLISH A RELATIONSHIP WITH THE PROPOSED LENDER TO ENABLE IT TO UNDERTAKE FROM TIME TO TIME DISCREET OPERATIONS OF A MEANINGFUL SIZE DIRECT WITH THE PROPOSED LENDER. THIS WOULD IMPROVE THE FLEXIBILITY OF THE BORROWER'S TOTAL FUNDING PROGRAMME WHICH AT PRESENT IS HEAVILY DEPENDENT UPON THE UNITED STATES DOMESTIC MARKET.

(B) THE BORROWER WOULD BE PREPARED TO PAY A PREMIUM IN TERMS OF THE COUPON FOR THE PROPOSED PLACEMENT OVER THE RATE WHICH IT WOULD BE REQUIRED TO OFFER ON A PUBLIC ISSUE OF SECURITIES IN THE UNITED STATES DOMESTIC MARKET ON THE UNDERSTANDING THAT THE SECURITIES WOULD NOT FLOW BACK INTO THE UNITED STATES.

STRUCTURE OF THE DOCUMENTATION FOR THE TRANSACTION

IT IS ENVISAGED THAT THE DOCUMENTATION FOR AN ISSUE OF SECURITIES BY MEANS OF A PRIVATE PLACEMENT OF THIS TYPE WOULD CONSIST OF THE FOLLOWING:-

(I) A NOTE PURCHASE AGREEMENT WHICH WOULD RECORD THE ARRANGEMENTS FOR THE ISSUE OF THE SECURITIES BY THE BORROWER AND THEIR SUBSCRIPTION BY AN AGENT ON BEHALF OF THE PROPOSED LENDER. THE SECURITIES TO BE ISSUED WOULD BE IN THE FORM OF REGISTERED NOTES. [THE AGREEMENT WOULD PROVIDE THAT SO LONG AS THE SECURITIES WERE HELD BY THE PROPOSED LENDER THE BORROWER WOULD PAY THE GROSS AMOUNT DUE IN RESPECT OF THE SECURITIES, IRRESPECTIVE OF WHETHER ANY SUCH PAYMENT IS SUBJECT TO ANY WITHHOLDING TAX. IN THE EVENT THAT THE PROPOSED LENDER DISPOSES OF THE SECURITIES OR ANY OF THEM AND THE BORROWER DETERMINES THAT AS A RESULT OF SUCH DISPOSAL IT WOULD BE REQUIRED TO PAY AN ADDITIONAL AMOUNT OF INTEREST TO THE HOLDER IN ORDER TO COMPENSATE FOR ANY WITHHOLDING TAX WHICH MIGHT BE APPLICABLE TO SUCH PAYMENT. THE BORROWER WOULD BE ENTITLED TO REDEEM THE SECURITIES ISSUED AT THEIR PRINCIPAL AMOUNT TOGETHER WITH ACCRUED INTEREST.]

delete

PRIOR MARKINGS

(II) AN AUTHORISATION AND CUSTODY AGREEMENT UNDER WHICH THE AGENT WOULD BE AUTHORISED TO ENTER INTO THE NOTE PURCHASE AGREEMENT ON BEHALF OF THE PROPOSED LENDER AND THE FEDERAL RESERVE BANK OF NEW YORK WOULD AGREE TO MAINTAIN THE REGISTER FOR THE NOTES AND ACT AS CUSTODIAN OF THE NOTES ISSUED.

(III) THE FORM OF NOTE AND THE TERMS AND CONDITIONS APPERTAINING THERETO. THESE WOULD INCLUDE THE NORMAL PROVISIONS RELATING TO PAYMENT OF INTEREST AND REPAYMENT OF PRINCIPAL, EVENTS OF DEFAULT, ETC.

GOVERNMENTAL CONSENTS REQUIRED BY THE BORROWER

THE INFORMAL APPROVAL OF THE FEDERAL RESERVE BOARD AND THE CONSENT OF THE U.S. TREASURY WILL BE REQUIRED FOR THE BORROWER TO UNDERTAKE A PRIVATE PLACEMENT TRANSACTION WITH THE PROPOSED LENDER.

(A) FEDERAL RESERVE BOARD - ALTHOUGH THE FORMAL CONSENT OF THIS AUTHORITY IS NOT REQUIRED, THE BORROWER HAS DISCUSSED WITH THIS AUTHORITY THE CONCEPT OF A PRIVATE PLACEMENT TRANSACTION WITH THE PROPOSED LENDER ON THE TERMS SET OUT IN THIS FRAMEWORK. FOLLOWING THESE DISCUSSIONS, THE BORROWER BELIEVES THAT IF THE TRANSACTION IS UNDERTAKEN IT WILL RECEIVE THE APPROVAL OF THIS AUTHORITY.

(B) THE U.S. TREASURY - THE BORROWER NORMALLY REVIEWS WITH THE TREASURY AT REGULAR INTERVALS ITS FINANCIAL REQUIREMENTS AND THE MEANS BY WHICH IT PROPOSES TO SATISFY SUCH REQUIREMENTS. A TRANSACTION OF THIS TYPE HAS BEEN MENTIONED DURING SUCH DISCUSSIONS AND THE BORROWER ANTICIPATES THAT A CONSENT WILL BE GIVEN FOLLOWING A SPECIFIC APPLICATION.

THE BORROWER HAS CONFIRMED THAT IT IS NOT SUBJECT TO ANY POLICY DIRECTION FROM THE TREASURY WHICH WOULD PROHIBIT IT FROM PAYING A FEE TO A FINANCIAL INTERMEDIARY FOR ARRANGING A TRANSACTION OF THIS TYPE.

4

I LOOK FORWARD TO HEARING YOUR COMMENTS WHEN YOU HAVE HAD AN OPPORTUNITY OF REVIEWING THIS TELEX. SHOULD YOU BE UNABLE TO REACH ME AT ANY TIME PLEASE CONTACT [redacted] WHO HAS BEEN WORKING WITH ME ON THIS MATTER

BEST REGARDS
[redacted]
MANAGING DIRECTOR
[redacted] BANK LIMITED, LONDON.
+++
SENT CPA 2249
FHLB OSF WSH

VIA ITT

FEDERAL HOME LOAN BANK BOARD

OFFICE OF FINANCE

TO Chairman McKinney
Board Member Miller

November 3, 1978

FROM Charlie Myers CM

SUBJECT: Direct Placement of FHLB Obligations with Foreign Central Banks or Governments-Specifically [[redacted] ([redacted])] *

I have attached a proposed framework for a possible direct placement of our obligations with [[redacted]] *This was developed by ourselves and representatives of [The [redacted] Bank, Limited, a London based consortium bank (The [redacted] [U.S.] Bank owns part of it - it is owned by large commercial banks in six countries).]

The only realistic foreign lender we can seek at this time is a central bank or government. Current IRS regulations specifically exempt these from withholding tax on the income from domestic securities. Other lenders would probably be subject to the tax and, hence, the investment would not be attractive.

I do not believe that this opportunity will be realized, due to a number of market reasons. Among these are the facts that Eurodollar rates are usually higher than those in our domestic market and that SAMA has been purchasing very few U.S. securities during the last six months. However, I propose the framework in case such an opportunity should arise. I seek your general agreement with the terms. Any real opportunity will be brought before you for specific consideration. I want you to be informed, just in case.

I am forwarding this framework to individuals at the Treasury and New York Fed for their information and comments. I will report back to you after receiving them. Please let me know if you object to any aspects of the statement. If not, I intend to inform the Orion people (and possibly those from other broker/dealer organizations) that they may proceed on this tentative basis, emphasizing that your specific approval and that of Treasury and the Fed must be obtained before any transaction can be consummated.

I recommend that you approve the framework. We can certainly use sources of foreign capital. Both Farm Credit and FNMA are ahead of us in this area. The .05% price concession for issuing them securities which we "understand" will not be repatriated seems to be slight, particularly considering that the placement fee we would be willing to pay the broker would be considerably less than what we would pay on a regular bond issue.

[Note: Middle East OPEC Government agency name deleted by F.H.L.B. Board]

The placement would be made via marketable securities of large denomination, registered at the Fed. [redacted] has stated that they purchase securities with the intention of holding them to maturity. I believe this has been true of almost all purchases they've made and will ask the Fed for their opinion. However, I have also been told by the [redacted] people that [redacted] does not wish to make non-marketable loans to us, instead maintaining the option of marketability, even though they don't intend to exercise it. To insist on a non-marketable issue would be tantamount to doubting their word. I believe the "risk" of repatriation is worth it, since we can monitor the securities because they will be registered at the Fed.

I will answer any questions you may have. I suggest this information be kept confidential.

cc: Bud Melton
Mark Korell
Jim McBride

B. FHLBB AND FHLMC DISCUSSIONS OF WAYS (A) TO CIRCUMVENT OR (B) TO ABOLISH THE 30-PERCENT U.S. WITHHOLDING TAX ON INTEREST PAID TO FOREIGNERS BY FEDERAL AGENCIES

Mr. Charles G. Myers,
Deputy Director,
Office of Finance,
Federal Home Loan Bank,
1700 'G' Street NW,
Washington DC 20552,
USA.

23rd June, 1978

Dear Charles,

We promised to send you our ideas on the taxation aspects of eventual possible borrowing by Federal Home Loan Bank in the Euromarket. What follows is inevitably preliminary and we have not at this stage sought advice or opinions on it from tax counsel. I hope however that it will prove useful as a starting point. In terms of the practicality of such operations, as you know the Euro-rates are presently higher than Domestic rates so that we could not at present make any proposals to you which would be of interest. However, the important thing is to be ready for 'windows' as they come along, or rather to see whether it will be practicable for you to make use of them.

Section 1441 of the U.S. Internal Revenue Code provides that interest paid to any non-resident alien shall be subject to withholding tax of 30%. (see Exhibit 1 for text of Section 1441).

There are three general ways in which interest can be paid abroad free of this 30% withholding tax.

1. Double Taxation Treaties

A number of countries have signed bilateral treaties with the U.S. which reduce (on a reciprocal basis) the withholding tax on interest paid by issuers in one country to investors in the other.

Countries where the withholding tax has been reduced to zero include:-

Austria	Netherlands
Denmark	Norway
Ireland	Sweden
Finland	U.K.
Greece	Zambia
Luxembourg	West Germany
Mali	

Other countries with reduced rates include:-

Switzerland (5%)	Belgium (15%)
France (10%)	Canada (15%)
Japan (10%)	Zaire (15%)

2.. Special Finance Vehicles

Utilizing the zero withholding tax treaty which exists with the Netherlands (including the Netherlands Antilles) and the fact that the Netherlands impose no withholding taxes on interest paid abroad, many U.S. companies have established Netherlands Antilles corporations to issue debt securities under the guarantee of the U.S. parent. This format is used where proceeds will be used within the U.S.

3. Specific Exemption

The U.S. Internal Revenue Code specifies certain exemptions from the 30% withholding tax.

Section 892: Interest income derived by foreign governments from investments in the U.S. is exempt from withholding taxes.

Section 895: This section states that "income derived by a foreign central bank from obligation of the U.S. or any agency or instrumentality.... which are owned by such foreign central bank and issue..... shall be exempt from taxation. For purposes of the preceding sentence the Bank for International Settlements shall be treated as a foreign central bank of issue" (See Exhibits II and III for full language of Sections 892 and 895).

Therefore, to be paid free of U.S. withholding tax, interest on a U.S. Government agency debt obligation must be paid:-

1. Through a N.V. subsidiary, or
2. To an investor in a country which has a zero reciprocal withholding tax treaty with the U.S., or
3. To a tax exempt organisation.

Although it is standard procedure for U.S. corporate borrowers, the first option is, as discussed, not currently available to you for policy reasons. It is possible that a change in policy could occur or indeed that the withholding tax legislation could be favourably altered,

/3..

although the view in Europe is that such developments are unlikely in the short term. The second alternative, while theoretically feasible, suffers from the requirement that, contrary to normal Euromarket practice, potential investors would need to identify themselves and their domicile to the Internal Revenue Service through filing Form 1001 to reclaim interest withheld. Furthermore, many of the countries with zero withholding tax treaties impose foreign exchange or other limitations which would significantly reduce investor demand from these countries.

It would therefore not be possible to distribute Eurosecurities on behalf of a U.S. government agency in the usual manner nor to maintain an active secondary market.

To take account of these difficulties, ________ would recommend a modification of normal Eurobond practice. Rather than distribute these securities on a withholding tax free basis, we would structure the issue on a fully taxable basis and direct the distribution effort exclusively to exempt investors.

Assuming that an issue by the Federal Home Loan Bank would qualify under both Section 892 and Section 895 (and an IRS ruling to this effect would be highly desirable) the issue would then be offered to:-

1) Foreign governments (Section 892)
2) Foreign central banks of issue (Section 895)

The issue would be a private placement. In view of the relatively short maturity (1 to 3 years) we would expect most of the investors to ask to hold the securities to maturity.

Nevertheless, some investors which are exempt institutions will want assurance of an after-market. ________ would be willing to act as a broker in the after-market and would attempt to place these securities with other exempt institutions. This, however, may not be an adequate after-market in the eyes of certain exempt investors. We would need therefore to explore with you the implications of the possibility of a return of securities to the U.S. market should our investors wish to sell. We would be most grateful for your views on the above and would be pleased to come to Washington for further discussions with you, the Treasury or the IRS.

I hope the above is of some interest and look forward to hearing from you in due course.

With best wishes,

Yours sincerely,

[Note: Name of London Bank & its office deleted by F.H.L.B. Board.]

EXHIBIT I

SEC. 1441. WITHHOLDING OF TAX ON NONRESIDENT ALIENS

(Sec. 1441 (a))

(a) GENERAL RULE - Except as otherwise provided in subsection (c), all persons in whatever capacity acting (including lessees or mortgagors of real or personal property, fiduciaries, employers, and all officers and employees of the United States) having the control, receipt, custody, disposal, or payment of any of the items of income specified in subsection (b)(to the extent that any of such items constitutes gross income from sources within the United States), of any nonresident alien individual or of any foreign partnership shall (except in the cases provided for in section 1451 and except as otherwise provided in regulations prescribed by the Secretary under section 874) deduct and withhold from such items a tax equal to 30 percent thereof, except that in the case of any item of income specified in the second sentence of subsection (b), the tax shall be equal to 14 percent of such item.

(Sec. 1441 (b))

(b) INCOME ITEMS - The items of income referred to in subsection (a) are interest (other than original issue discount as defined in section 1232(b)), dividends, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income ......

23.6.78

EXHIBIT II

SEC. 892. INCOME OF FOREIGN GOVERNMENTS AND OF INTERNATIONAL ORGANIZATIONS.

The income of foreign governments or international organizations received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments or by international organizations, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments or international organizations, or from any other source within the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle.

75-298

23. 6. 78

86-722 0 - 82 -72

Goldman, Sachs & Co. | 55 Broad Street | New York, New York 10004
Tel: 212-676-8346

Daniel W. Hofgren
Vice President
Corporate Finance Department

Goldman Sachs

April 11, 1978

Mr. Philip R. Brinkerhoff
President
Federal Home Loan Mortgage Corporation
321 First Street, N.W.
Washington, D.C. 20001

Dear Phil:

I am writing this letter for the purpose of making a formal proposal to you to do a Eurobond offering pursuant to our previous conversation.

I am enclosing the proposed terms of guaranteed notes on the basis that we previously discussed.

It is our opinion that such an issue is available for the Federal Home Loan Mortgage Corporation at this time and we urge you to proceed as soon as possible.

I am available to discuss any questions that you might have.

Sincerely,

Daniel W. Hofgren

DWH:ag
Enclosure

FEDERAL HOME LOAN MORTGAGE CORPORATION N.V.

Proposed Terms of

Guaranteed Notes due 1983

Issuer	-	Federal Home Loan Mortgage Corporation N.V., a Netherlands Antilles company.
Guarantor	-	Federal Home Loan Bank Board.
Issue	-	U.S. $250,000,000 principal amount of Guaranteed Notes due , 1983.
Offering Restrictions	-	Not offered in the United States or to nationals or residents of the United States or to residents of the Netherlands Antilles.
Maturity	-	Five years.
Interest	-	8% coupon, payable annually.
Redemption	-	Not redeemable, except that the Notes may be redeemed at any time if certain withholding taxes become payable.
Listing	-	The Notes will be listed on the Luxembourg Stock Exchange.
Form and Denomination	-	Bearer bonds in denominations of $1,000 and $10,000
Negative Pledge	-	The Issuer and Guarantor will covenant that if in the future either shall secure any foreign borrowings by any lien, pledge or other charge on any of its present or future assets or revenues, the Notes shall share in and be secured by such lien, pledge or charge equally and ratably with such other foreign indebtedness or borrowings.
Issue Price	-	100%, subject to market conditions.
Gross Spread	-	Underwriting - 0.375% Management - 0.250 Selling Concession - 1.250 Total 1.375%
Underwriters' Expense Reimbursement	-	None

2.90 normal spread

April 10, 1973

.<ISPMC WSH
X
FHL MC WSH

WU INFOMASTER 1-025030C101 04/11/78
TLX GOLDSACHS NYK
01 NEW YORK NY APR. 11
TWX 7108220244 FHL MC WSH
FEDERAL HOME LOAN MORTGAGE CORPORATION WASHINGTON
ATT: MR. PHILIP R. BRINKERHOFF PRESIDENT

MR. DANIEL HOFGREN SENT THE FOLLOWING PROPOSAL TO YOU IN THE MAIL TODAY:

DEAR PHIL:

I AM WRITING THIS LETTER FOR THE PURPOSE OF MAKING A FORMAL PROPOSAL TO YOU TO DO A EUROBOND OFFERING PURSUANT TO OUR PREVIOUS CONVERSATION. I AM ENCLOSING THE PROPOSED TERMS OF GUARANTEED NOTES ON THE BASIS THAT WE PREVIOUSLY DISCUSSED. IT IS OUR OPINION THAT SUCH AN ISSUE IS AVAILABLE FOR THE FEDERAL HOME LOAN MORTGAGE CORPORATION AT THIS TIME AND WE ~~[illegible]~~ URGE YOU TO PROCEED AS SOON AS POSSIBLE. I AM AVAILABLE TO DISCUSS ANY QUESTIONS THAT YOU MIGHT HAVE.

FEDERAL HOME LOAN MORTGAGE CORPORATION N.V.

PROPOSED TERMS OF

GUARANTEED NOTES DUE 1983

ISSUER

FEDERAL HOME LOAN MORTGAGE CORPORATION N.V., A NETHERLANDS ANTILLES COMPANY.

GUARANTOR

FEDERAL HOME LOAN BANK BOARD.

ISSUE

U.S. DLRS 250,000,000 PRINCIPAL AMOUNT OF GUARANTEED NOTES DUE 1983.

OFFERING RESTRICTIONS

NOT OFFERED IN THE UNITED STATES OR TO NATIONALS OR RESIDENTS OF THE UNITED STATES OR TO RESIDENTS OF THE NETHERLANDS ANTILLES.

```
MATURITY
--------
FIVE YEARS.

INTEREST
--------
8 O/O COUPON, PAYABLE ANNUALLY.

REDEMPTION
----------
NOT REDEEMABLE, EXCEPT THAT THE NOTES MAY BE REDEEMED AT ANY TIME
IF CERTAIN WITHHOLDING TAXES BECOME PAYABLE.

LISTING
-------
THE NOTES WILL BE LISTED ON THE LUXEMBOURG

STOCK EXCHANGE.

FORM AND DENOMINATION
---------------------
BEARER BONDS IN DENOMINATIONS OF DLRS 1,000 AND DLRS 10,000

NEGATIVE PLEDGE
---------------
THE ISSUER AND GUARANTOR WILL COVENANT THAT IF IN THE FUTURE
EITHER SHALL SECURE ANY FOREIGN BORROWINGS BY ANY LIEN, PLEDGE
OR OTHER CHARGE ON ANY OF ITS PRESENT OR FUTURE ASSETS OR
REVENUES, THE NOTES SHALL SHARE IN AND BE SECURED BY SUCH LIEN,
PLEDGE OR CHARGE EQUALLY AND RATABLY WITH SUCH OTHER FOREIGN
INDEBTEDNESS OR BORROWINGS.

ISSUE PRICE
-----------
100 O/O, SUBJECT TO MARKET CONDITIONS.

GROSS SPREAD
------------
UNDERWRITING    -     0.375 O/O
MANAGEMENT      -     0.250
SELLING
   CONCESSION   -     1.250
                      ------
      TOTAL           1.875 O/O

UNDERWRITERS' EXPENSE
---------------------
REIMBURSEMENT         -NONE
-------------

APRIL 10, 1978

SINCERELY

DANIEL W. HOFGREN
GOLDSACHS

1515 EST

NL MC WSH
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FILE CLASSIFICATION:

MEMO

The Mortgage Corporation

From Maud Mater

Date January 16, 1979

To Phil Brinkerhoff

Subject International Sales

cc: Hank Judy

Hank recently indicated to me that the Chairman, Mike Rush and Charlie Myers are planning a European trip toward the end of January to discuss the desirability and feasibility of marketing FHLMC securities abroad. A number of people from Goldman Sachs also may be involved. As I understand it, the group plans to visit with a number of major financial institutions which are both potential investors and knowledgable about sales potential to other members of the European financial community. I understand that the group also may meet with the financial press in London. I also understand that this is an initial exploratory and information gathering trip and that no commitments are intended.

I have some concerns about this trip. These concerns fall into two general categories. The first relates to the substance of discussions and the impression that the group will make. The second relates to the level of awareness at the Corporation of the resources which likely will be necessary in order to engage in international sales transactions. The common denominator is whether the Corporation has a clear understanding of what we may be getting ourselves into -- particularly from an international tax standpoint.

1. Impressions. I assume that the types of people the Corporation group will meet with will be quite sophisticated in the area of international investments generally -- and most specifically concerning international tax issues and devices. International tax is a sufficiently complex area that even quite sophisticated businessmen can get out of their depth quite quickly. Examples of the complex questions which likely will arise (and as to which the Corporation's representatives ought to have some awareness) are discussed below.

   My principal concern is that the Corporation not come across as unsophisticated or ill-informed. To the extent that we do not come across as financial professionals, the European financial community may be less willing to deal with us, may have less faith in our guarantee, and may be more inclined to "pull" things on us. So far as I am aware, no one in the Corporation group knows a great deal about international investments or international tax. What makes most sense to me is to make sure that people from Goldman are experienced in the international area. If we are somewhat unsophisticated, but smart enough to seek the counsel of experts, then we likely will come across just fine.

FHLMC 89 4-78

2. Substantive Issues.

The international tax issues would involve both U.S. laws and foreign laws applicable to foreign nationals purchasing securities from a U.S. seller. Foreign currency control laws might also be relevant, depending on the countries into which we would be selling.

a. The most important U.S. laws in this area involve taxation of interest paid to non-resident aliens. The most critical feature of these laws (to which there are numerous exceptions) is the imposition of a 30% withholding tax on U.S. source interest income paid to non-resident aliens. As a practical matter, the imposition of this level of tax renders U.S. investments unmarketable vis a vis yields obtainable on competing investments which are not subject to this tax.

One of the most useful exceptions to this 30% withholding tax involves foreign jurisdictions with which the United States has particular types of treaties. (One such jurisdiction, which is the favorite of many lawyers, is the Netherlands Antilles.) Typically, a U.S. company desiring to sell securities abroad will either set up what's known as an International Finance Subsidiary (IFS), or sell its securities to an Offshore Investment Fund (OIF). An IFS normally is a subsidiary of the securities issuer, but we might use an established subsidiary of a European bank, broker or underwriter. An OIF is really a type of mutual fund, and foreign investors invest in U.S. securities through the fund.

b. On foreign laws, it is difficult to say much that is meaningful of a general nature. Most countries have specific tax laws dealing with foreign investments by their nationals. These laws vary considerably in substance and severity. They also vary by type of investor -- e.g., corporations, partnerships, individuals.

c. The Corporation would face particularized issues because of the type of entity we are and the type of securities we issue. For example, it is not clear whether the Corporation has the statutory authority to establish a subsidiary. As a further example, many of the treaties which make IFS's and OIF's possible do not cover interest earned on mortgages, and this fact might limit the foreign marketability of PCs.

I don't want to burden you with the complexities of international tax at this point; my purpose is to give you a feel for the level of legal work which would be involved. Legal can do the necessary legal work with assistance from Cadwalader -- which has a New York partner who specializes in this area.

3. Costs.

International tax work literally eats money. The level of intricacy translates directly into dollars. Setting up an international sales operation of any size could easily cost $200,000 in outside legal fees. In view of the

Chairman's concern about Legal's outside counsel budget, I think it would be prudent to give him some idea of the dollars involved before we get much further along.

With this background in mind, let me ask you a few questions:

1. Some months ago we sent Mike a package of background materials on international sales prepared by CWT. Have these been shared with the Chairman and Charlie Myers?

2. Do you feel that the Chairman and Charlie have been adequately briefed? Are we relying on Goldman Sachs to do this or should we speedily put some briefing materials together?

3. In general, is there anything you want Legal to do to help prepare our group for this trip?

MM:erm

FILE CLASSIFICATION: MKT 3

MEMO

The Mortgage Corporation

From Maud Mater Date July 17, 1979

To Mary Bruce Batte Subject Foreign Investment in FHLMC Securities

cc: Bill Nachbaur (w/o attachments)

Attached are all of the relevant materials which Legal has on this subject. I need to make a few comments on these materials, and some of these points are ones which I mentioned when we talked. However, this is a sufficiently complex area that I need to create a written record of my own thinking so that I don't have to reinvent the wheel every time we get into this area.

First, as an internal matter, it needs to be understood that international tax is an extremely complex area from a legal standpoint. It is also an area in which Legal has done relatively little work to date for the reason that relatively little has been needed. The result is that we know the answers to some questions and not to others. We can get whatever answers are needed but the service may not be instantaneous.

Second, from a substantive and political standpoint, the following matters occur to me:

1. The U.S. withholding tax "problem" is of a statutory rather than regulatory nature. Treasury may have the flexibility to give us a little regulatory relief, but I seriously doubt that they can do much. Our choices are essentially (1) legislative relief, (2) the establishment of an offshore subsidiary, or (3) a combination of (1) and (2).

2. The U.S. withholding tax law is by no means the only issue. Foreign tax laws and currency controls are also involved. Further, these laws differ from country to country.

3. Treasury's securities also are subject to the U.S. withholding tax law, and this is almost certainly the reason for Treasury's interest in this area. If Treasury is considering legislative relief for the purpose of marketing its paper, then we could tag along. However, it seems unlikely that Treasury would be very interested in legislative relief for the Corporation alone as such relief would put us in a more favorable position vis a vis both Treasury and FNMA. Further, I think our board of directors might have a problem with more favorable tax treatment for FHLMC securities than for Bank System securities. Since FHLBank securities compete fairly directly with Treasuries, it is possible that Treasury might even oppose a favorable tax amendment for FHLBank and FHLMC securities.

4. If Treasury and others were to sponsor legislation to exempt all U.S. governmental securities from the withholding tax law, such a

bill might well get caught up in the various international finance controversies which are currently in the newspapers. If this happens, then such legislation could take awhile to get through the Congress.

5. Our board of directors probably would want to clear any legislative effort in the international sales area; they probably also would want to clear any significant exploration of the establishment of an offshore subsidiary. In this connection, I suspect that Acting Chairman Miller would ask whether an effort to market internationally would divert any significant level of resources from the developmental purchase programs which are so important to her. I think the answer is that some resources in the marketing, legal, accounting and systems areas would be diverted. I do not have a good feel for the level of diversion, but it could be substantial. I think we would want to get a handle on this before we approached the Board on this subject, particularly since the Board has just adopted an operating plan for 1980 which does not focus specifically on the international investment area.

In general, I would recommend that you and Charles find out what Treasury is doing, inform Phil, and get him to make a policy decision on where he wants to go and on what schedule. If he does want to approach the Board in the relative near future, then we may have some internal work to do before talking with them.

Please keep me posted on developments in this area. Also, please let me know what further assistance you need.

MM:cls

Attachments

FILE CLASSIFICATION: File

MEMO

The Mortgage Corporation

From Phil Brinkerhoff

To Maud Mater

Date January 18, 1979

Subject International Sales

noted 1/21

I appreciated receiving your memo on this subject. I share your concern that the group make a positive impression on potential investors.

I have had numerous discussions with principals at and , the co-sponsors of the trip to Europe. These are knowledgeable, well informed people in the area of international investments. Each has European offices staffed with professionals who are sophisticated in the trading of Eurobonds and other foreign investment transactions. They will be the front people in terms of discussing the international trading aspects of FHLBB and FHLMC securities. The Chairman, Charlie and Mike Rush will be there to underscore the interest of the FHLBB and FHLMC in pursuing international sales of securities and to explain the operation and soundness of each entity.

As far as the international tax issues are concerned, I have discussed this issue at some length with both representatives of and We are all keenly aware of the implications of the withholding tax, and have alternative ways of addressing that issue. The Treasury Department is also very aware of this trip and what is sought to be accomplished by it. The methods of addressing the withholding tax issue include: legislation to exempt government securities from the withholding tax (the Treasury may be in favor of this because its own securities are affected) and setting up a foreign based subsidiary to issue the securities. The latter is a realistic possibility since FNMA has a subsidiary based in the Netherlands Antilles, and it is my understanding that they have issued securities abroad using this facility with the approval of the Treasury Department.

These investment bankers have made numerous trips abroad with American companies, including FNMA, for the last five or six years. They are knowledgeable, competent professionals with a firm grasp of all relevant issues concerning international trading of securities, including government agency and instrumentality securities. It is equally as much to their advantage as to ours that the trip go well. I feel comfortable that it will be a successful endeavor in terms of introducing our securities to the foreign marketplace. I am not sanguine that it will result in early sales of securities by the Corporation, because of some of the issues that you raised and the complexities of these transactions. However, the investment potential inherent in the international marketplace is so great that I feel it will be very much to our advantage to get the ball rolling in this area.

Once again, thank you for your thoughtful analysis of this issue. I believe that Charlie, Mike and the investment bankers have the trip well in hand, and I can't think of anything that Legal should do at this point to help to prepare the group further for the trip.

PRB:ml

NINETY-SEVENTH CONGRESS

Congress of the United States

House of Representatives

COMMERCE, CONSUMER, AND MONETARY AFFAIRS
SUBCOMMITTEE
OF THE
COMMITTEE ON GOVERNMENT OPERATIONS

RAYBURN HOUSE OFFICE BUILDING, ROOM B-377
WASHINGTON, D.C. 20515

MEMORANDUM

TO: FILES

FROM: Stephen R. McSpadden
Subcommittee Counsel

SUBJECT: Telephone Conversation on 3/24/80 with Andrew Hickey, Federal National Mortgage Association

1. Dutch Antilles Corporation set up by FNMA is named "FNM Overseas Capital Corporation." It was created by FNMA to market FNMA securities.

2. It was created on June 26, 1974, and is still in existence.

3. It has never been used to sell FNMA securities. Hickey did not know reasons for this.

SRM:dfb

FEDERAL HOME LOAN BANK BOARD

OFFICE OF FINANCE

TO Anne Jones July 7, 1978

FROM Charles G. Myers CM

SUBJECT: I Need A Good Lawyer

Currently we are trying to borrow funds for the Bank System from European sources. An overriding obstacle is the IRS requirement that 30% of the interest paid be withheld for taxes. There is, however, an exemption to this rule if the owner of the security is a foreign government, or a foreign central bank provided the security is issued by an "agency or instrumentality" of the government.

A Bank in England has shown an interest in acting as broker on our behalf to find a Central Bank purchaser for a direct placement. They say it is desirable to have the IRS rule that our securities are indeed covered by this exemption.

Is it possible to obtain such a ruling from the IRS within a month or so? How should we ask for it? If this might take some time, I suspect that an opinion from you would be sufficient. Will you do it?

I've attached a copy of a letter which explains the situation in greater detail.

Thanks

Att.
6/22/78 Letter from

FEDERAL HOME LOAN BANK BOARD

OFFICE OF FINANCE

TO Rebecca H. Laird November 7, 1978

FROM Charlie Myers CM

SUBJECT: Legislative Topics

There is one I'd like to suggest. The current tax code requires foreign investors in U.S. federal agency securities to be subject to a 30% withholding tax on the interest, with some exceptions for foreign central banks and governments. It would be helpful to the FHLBanks and the Mortgage Corporation if foreign investors could hold our securities without being subject to this tax. I would like to propose that we pursue a legislative change which would accomplish this. We would have support from the Farm Credit System and FNMA, and their friends in the Congress (the Agriculture Committee, etc.).

FEDERAL HOME LOAN BANK BOARD

OFFICE OF FINANCE

TO Chairman McKinney February 26, 1979

FROM Charlie Myers CM

SUBJECT: Withholding Tax on Foreign Investors

I have attached a reply to [*]'s letter which was accompanied by a memorandum on the Withholding Tax question. At this time I don't think we should encourage a visit from one of their senior partners to brief us on the problem. He probably couldn't add anything we don't already know.

It seems clear that some action by Congress removing the withholding requirement will be necessary before we can issue Eurodollar securities. I've spoken with Aubrey Johnson, Fiscal Agent of Farm Credit, and Bob Bennett, Executive Vice President of FNMA, about this common issue. Both Farm Credit and FNMA are interested in pursuing this.

The ideal approach is to convince Treasury to initiate the action with the beneficiaries staying in the background. This will require considerable prodding and I will be surprised if they do so. An alternative is for the three agencies to make the effort directly, concentrating on changing the law to exempt only the agencies. Our success would still probably require the consent of Treasury.

Bob Bennett suggested to Oakley Hunter that you and he meet sometime soon to discuss possible strategy. I recommend your doing this. FNMA has the services of Charls Walker as consultant (he has not registered as a lobbyist, yet) so we might want to be careful how closely we appear to be working with them. If we can marshall the support of the Agriculture Committee via Farm Credit, we should have fairly broad support. I suggest that Aubrey Johnson and the Governor of FCA be present at the meeting.

Please let me know if you want me to arrange a meeting, if you will do it directly or if we should let this issue rest for a while.

[* Member of large U.S. brokerage firm; deleted by FHLBB]

OFFICE OF FINANCE

TO Chairman Janis September 27, 1979

FROM Charlie Myers CM

SUBJECT: Foreign Investors and the 30% Withholding Tax

I have attached several memos discussing the withholding tax with Chairman McKinney.

It is my current understanding that Treasury may propose a change in the statute, exempting interest but not dividends from the tax. If Congress does not appear receptive they may fall back on a proposal to exempt only the Treasury's and agencies' debt instruments. I'm not sure how much support they have so it would be advantageous to express at least our interest in the matter through a conversation between Carswell and yourself.

Needless to say it is very important that we develop foreign sources of capital. We will present several items on next year's budget toward this objective, having learned from our first presentation to European investors last Winter. Among these are a trip or two for yourself and/or another Board Member and a succinct brochure describing the FHLBank System directed toward foreigners. They were quite receptive to our securities but the withholding tax eliminates any serious interest except for central banks.

I've also included for your information a proposed framework for a private placement which we developed last year. So far there has been no interest on the part of foreign investors.

cc: Rita Fair
Dale Riordan

OFFICE OF FINANCE

TO Chairman Janis October 29, 1979

FROM Charles Myers CM

SUBJECT: Withholding Tax on Foreign Investors

Attached is a copy of a change to the tax code which I understand will be introduced on behalf of the Treasury Department. Assistant Secretary (Tax Policy) Lubick has issued a policy statement supporting it. They have obtained the support of the White House and OMB. They are now choosing a vehicle for attaching this as a rider.

I will forward a copy of Treasury's policy statement when I get one. Perhaps you could call Carswell to confirm their intentions and offer our support before you leave on vacation.

[Draft of 10/25/79]

Be it enacted, etc. that:

Subsection 861(c) of the Internal Revenue Code of 1954 (dealing with the exclusion of certain interest from gross income from sources within the United States) is amended by adding at the end thereof a new paragraph as follows:

"(4) A debt obligation of a domestic corporation or a debt obligation of the United States, any agency of the United States or any corporation created or reorganized either by an Act of Congress or by an agency created by an Act of Congress, but only if

(A) in the case of a domestic corporation, immediately after the issuance of such debt obligation, either --

(i) United States persons own, directly or indirectly, stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote of such corporation; or

(ii) such debt obligation is held by a person who does not own, directly or indirectly stock possessing 10% or more of the total combined voting power of all classes of stock entitled to vote of such corporation;

(B) such debt obligation is part of an issue which --

(i) was issued after , 1979, and the document evidencing such obligation includes a statement that such obligation is part of an issue intended to meet the requirements of this paragraph; or

(ii) resulted from the assumption after such date by a domestic corporation of an obligation of another corporation which obligation at the time of issuance met the requirements of subparagraph (C) and either (i) or (ii) of subparagraph (A) and which was guaranteed by the assuming corporation at the time of issuance and prior to ______________, 1979; and

(C) such debt obligation is part of an issue which when issued --

(i) had a maturity of not more than 20 years; and

(ii) was intended to be sold, directly or through underwriters, only to persons who were not United States persons.

This paragraph shall not apply to interest paid or accrued on a debt obligation described in subparagraph (B)(ii) prior to the date on which such obligation was assumed."

C. FHLMC'S ABILITY TO DETECT FOREIGN INVESTMENT IN ITS SECURITIES AND ATTEMPTS TO OBTAIN THAT INFORMATION

FILE CLASSIFICATION:

MEMO

The Mortgage Corporation

From	Maud Mater	Date	January 31, 1979
To	Rick Cohn	Subject	Treasury Department Survey on Foreign Investment

Attached is a blank survey on the captioned subject, together with related incoming materials. I have talked with Niesa and Barbara, and they tell me that at present there are no foreign investors in our securities. Hence, the report should be a cinch to fill out. I think Accounting is the appropriate department to fill it out, and I suggest you contact Niesa to determine to whom in Accounting it should be sent. It's not due until March 31, so there's plenty of time.

More generally, I am not clear as to the level of inquiry we need to make concerning foreign investors. My understanding has always been that we need not inquire further if the investor furnishes us with either a Social Security number or a U.S. tax I.D. number. Any investor not having one or the other of these numbers is a foreign national as to which there is a withholding tax issue. The corollary is that Treasury determines that an entity is not a foreign national for withholding tax purposes prior to issuing numbers.

I've asked Charlie Adelman to do some checking and verify my understanding in this area. Charlie should get back to us in a week or so, and the information will need to be disseminated to Accounting and Marketing. When the information comes in, I'll give it to you for this purpose. I want to get this area nailed down before we actually have a foreign investor.

MM:erm
Attachments

FHLMC 89 4-78

JAN 24 1979
FILE CLASSIFICATION: 18

file

MEMO

The Mortgage Corporation

From	Linda Callahan Linda	Date	January 23, 1979
To	Maud Mater	Subject	Foreign Investment Survey

The attached survey was sent to Marketing, but after looking through the information requested, I think it is more properly handled by Legal. Some of the information requested will have to be supplied by Marketing. However, the data related to registered holders of our securities as of year end, will not be available until sometime after February 15. Additionally, the accuracy of the holders profile is somewhat questionable since so many of our securities are registered and held in nominee name. (I have attached a copy of last year's profile to give you an indication of the volume I am referring to.)

Along a similar vein, we have received a request from one of our dealers asking for a letter from the corporation to one of his customers guaranteeing that we would not withhold any portion of interest from an investment by a foreign concern. I have no idea if the request is related in any way to the survey, but they both hit us at about the same time.

I would appreciate if you could give us a response as soon as possible. If we can help with the survey in any way, please let us know.

talked with Linda. We can't possibly issue such a letter. if there is any question as to the applicable law with respect to a particular investor, it is more likely that we would request a letter from the investor to the effect that we need not withhold tax. We are the ones who are liable if the tax is not withheld.

/mas
attachment

FHLMC 89 4-78

D. FHLBB CONCERNS ABOUT ARAB BOYCOTT/DISCRIMINATION AGAINST CERTAIN U.S. BROKERAGE HOUSES AND SECURITIES DEALERS

FEDERAL HOME LOAN BANK BOARD

OFFICE OF FINANCE

confidential

TO The Files February 3, 1976

FROM Marshall Burkes MB

SUBJECT: OPEC Orders for FHLB Securities

Following the Discount Note meeting with the Board on Friday, January 16, 1976, I reviewed our November Financing experience with SOMA. We also discussed the position taken by the other Fiscal Agents which includes travel to the OPEC countries and treatment during agency offerings. We stressed our desire to control our sale and allocate those dealers that do the best job for us. This was particularly helpful in the November GMC sale where some last minute assistance was needed by the dealers that were rewarded with the OPEC orders. However, I acknowledged that to date the U. S. dealers have not been called upon to assist the OPEC countries in the secondary market.

After some discussion, it became apparent that each Board Member preferred that we handle the OPEC orders through the FED and not provide a concession to the dealers. This was based on the following concerns without specific documentation:

1. Avoid possible charges of discrimination against dealers with non-Arab affiliation.

2. The OPEC countries want to recognize only a portion of the list of recognized dealers.

3. Questionable amount of service provided by a U. S. dealer to the investor.

4. These orders had not been made public at the beginning of each sale last year. The burden of fairness to all investors (U. S. and non-U. S.) is on us in case of any questions.

I indicated that we must be prepared to forfeit this business and pay a slightly higher yield for our securities if the OPEC countries quit doing business with us. Also, the other Fiscal Agents will probably continue paying the concession and working with some kind of dealer list in the future. With that as the background the Board reinforced its conclusions.

The above reasoning was explained to Peter Sterlight in the absence of Paul Meek who was ill. Mr. Sterlight indicated that he had sympathy for our posture, but asked that I review this with Ed Yeo. I indicated that I had already discussed it with Mr. Forbes and Mr. Cook. Mr. Cook indicated that that's the way it should have been all along if the Fed and the Treasury had only gotten together.

Mr. Yeo returned my call on Sunday, January 25, and was quick to indicate he doubted the Board's reasons for concern. I restated the Board's concern and he said that he would like to give it some more thought. One of his alternatives seemed to be his letting the OPEC countries go to the dealers of their choice which has some unfortunate ramification besides not finding sufficient bonds early in the sale. Mr. Yeo indicated he would call us back if he had additional thoughts, but he was clear on our posture in advance of our February financing. Last Friday we discussed the February financing with the Fed and they had already relayed our earlier posture to SAMA. The SAMA TWX acknowledged our posture and indicated they hoped that the Fiscal Agent got to keep the concessions (personally). We assured the Fed that we would hold bonds available to their customers until 11:30 am on Monday morning. SAMA did not order bonds with the five-year maturity which is the exact maturity that they ordered in November for $50 million. We would not draw any hasty conclusions at this point.

Bill Cleaver April 4, 1975

Marshall Burkes

Concession to Certain Dealers on Mid East Oil Money

Bob Cooper of the New York Fed called to discuss a potential procedure for including dealers in orders for agency purchases. Apparently [redacted] would like to consider purchasing $50 million or more on a fairly regular basis from the agencies. Treasury has shifted the fee question to the Fed with the impression that fees should not be involved. However, Cooper asked if we would be agreeable to selecting names from the following list of eleven dealers: First Boston, White Weld, Morgan Guaranty, First National City Bank, Continental, Bankers Trust, Chemical, Merrill Lynch, Discount, Goldman Sachs and Kidder Peabody.

I asked if there was any political discrimination with the Fed's list of recognized dealers. Bob Cooper said no, but did not elaborate. I indicated that we would have no objection to selecting from the above list. We would probably select on the basis of performance during the sale and make the allocation as broad as practical. Thus, for a $50 million purchase we would probably involve five dealers.

I don't know whether Farm Credit and FNMA have agreed to this procedure. We understand that Farm Credit went short on a recent purchase by the [redacted] and complicated the bookkeeping for a while. It is interesting to note that such recognized dealers as Chase, First of Chicago and Bank of America were not included.

[Note: Name of Middle East OPEC country deleted by F.H.L.B. Board.]