1980
TWO DOLLARS

Forbes

RECYCLING PETRODOLLARS

HOW MUCH MORE CAN THE SYSTEM TAKE?

RECYCLING PETRODOLLARS

The current news is: Inflation is slowing down in the U.S. But for how long and by how much? The world seems to be on a merry-go-round of inflation and there is no way for one country or one businessman to say, "Stop the merry-go-round, I want to get off." Since 1973 the price of oil, lifeblood of modern industry, has been jacked up by an extortionate 1,000%. That this hasn't caused a massive world depression is due principally to the unexpected ability of the world's commercial banks, with minimal help from their governments, to recycle the flood of petrodollars that piled up, first in 1973 when the price of oil was trebled, and again last year when it was doubled. But the price paid for this has been inflation, with the recycled petrodollars providing international liquidity unparalleled in history. The inflation, in its turn, has made the oil price boosts more bearable while goading OPEC to raise prices further. Inflation and oil. The two are intimately connected: oil and financial liquidity, financial liquidity and inflation. While the huge U.S. trade deficits of the late Sixties started the whole inflationary spiral, it has been oil and money market multipliers, spawning ever larger increases in credit year after year, that have kept it going.

Too much contemporary journalism is crisis journalism—written as though events have taken place in a vacuum, as though they do not have roots and parallels in history. In this article—long for FORBES—Contributing Editor Norman Gall looks at the current world financial crisis from a historical as well as a contemporary perspective. He compares today's money explosion with the long inflation bred by the arrival of Spanish treasure galleons from the New World in the 16th century and the spread of new liquidity throughout Europe. And he cites history to disprove the bankers' argument that sovereign states never default on their debts. We now face, Gall claims, a tough choice: Either we accept continued, possibly accelerating, inflation, or we accept a slowing of world economic growth. Either course poses incalculable risks to rich nations and poor nations, capitalist states and socialist states alike.

HOW MUCH MORE CAN THE SYSTEM TAKE?

Walter Wriston, meet Lorenzo de' Medici

What's good anti-inflation policy in Washington may be disastrous in Ankara or Brasilia or many other corners of the world. Where does all this leave the big international banks? In trouble.

By Norman Gall

IN THE 14TH CENTURY a poor, less-developed country began to make its influence felt in the international economy as a major exporter of a basic raw material. The country was England. The product was wool. Sophisticated Italian bankers, sensing opportunity in England's exportable surplus and the rest of Europe's need for wool, moved in. The bankers were shocked by what they saw. Here was a brawling, backward country whose rulers were always fight-ing civil wars. So primitive was the economy that money was very scarce, and the monarchs were chronically short of the wherewithal to pay their proops. To get an assured supply of wool, the Italian bankers made English loans. But the English turned out to be deadbeats, and England's creditors had to do what the English themselves did centuries later: take control of customs to collect what was due them. Even then the bankers didn't always get out with a whole skin. The famous Medici bank of Florence staked Ed-ward IV in the savage Wars, of the Roses. Edward won, but his purse was empty and many of the lesser customers lay dead on the battlefields. The Medici bank never fully recovered from its losses. When bankers tell you not to worry, that sovereign countries "can't" default on their loans, remind them of the Medicis, remind them of London's famous Baring Brothers destroyed by Argentinian defaults, remind them of Russia's defaults on czarist bonds and of all the U.S. jurisdictions that defaulted on loans from Europeans in the 19th century. Remind them that Spain -- though it was the OPEC of the 16th century by dint of its control of the New World's gold and silver -- defaulted at least eight times on debt owed to foreign bankers. Almost every major bank in the world is today an international bank and deeply involved in what goes on beyond its nation's borders -- which essentially changes all the rules. U.S. banks are taking 90-day deposits from OPEC sources and lending them to less-developed nations for terms as long as ten years. Half of Bank of America's deposits are for-eign today, up from 31% in 1971; Citicorp's are 75%, up from 44%. By the end of 1978 U.S. commercial bank loans to Brazil and Mexico alone equaled the combined capital of the 12 largest U.S. banks. And not just the American banks. Among the Japanese banks, three-quarters of their overseas loans are to developing countries. All this overseas activity adds to the upward pressure caused by domestic inflation on the demand for loans. Put simply, bank lending has far outstripped the growth of bank capital. As recently as the mid-1960s the prevailing rule of thumb for prudent banking was to limit outstanding loans to about 15 times capital in order to maintain enough reserves to absorb potential loan losses. During the international lending boom of the 1970s, this multiplier rose steadily until it reached an average of almost 30-to-1 for the eight largest U.S. money center banks. Among U.S. banks, Chase Manhat-tan's outstanding claims are 31 times capital; Chemical's,

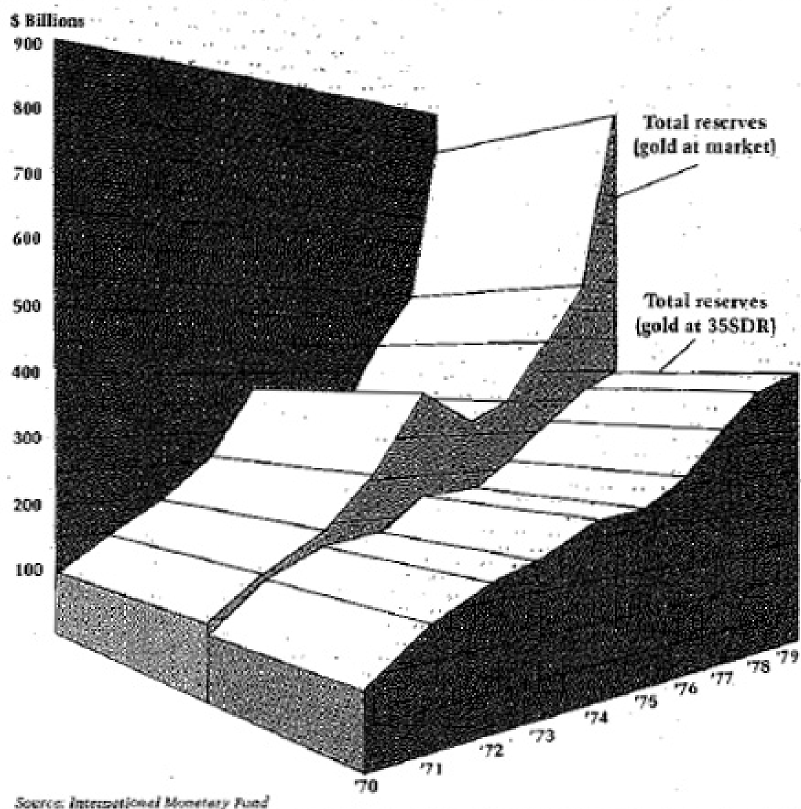
Renaissance banker Lorenzo de' Medici

What do you do when you try to finance the foreign trade of a backward, brawling country like England in the 14th century? If need be, you take over their customs in order to collect.

33; Continental Illinois, 26; Bankers Trust, 37; Irving Trust, 31. For Japan's largest bank, Dai-Ichi Kangyo, the multiplier is 42, and for Fuji Bank, Japan's fourth largest interna-tional lender, it is 36. Deeply involved as they all are in international lending, these giant banks could conceivably have their joint total capital wiped out by a series of defaults on the international scene. Like backward, brawling 14th-century England, the poorer countries of the world are now deep in debt to the over-extended bankers of the richer nations and, like many old monarchies, they can service their debts only by borrowing more. To say that sovereign states cannot default is to ignore history. Earlier, this year, in bankers' language, Federal Reserve Governor Henry C. Wallich spoke some unpleasant truths. He told a meeting of bankers that commercial bank loans to the poorer countries had grown 23% a year on average since 1975, nearly trebling in five years. "Such a rate of growth," he said, "exceeds the rate of overall credit expansion that can be sustained by any banking system not in the grip of galloping inflation. For the longer run one must ask whether the world's banking system can meet increased demands by less-developed countries even if these demands reflect genuine investment financing rather than the financing of consumption-oriented oil imports." Wallich was saying: The party in nearly over; it has been going on too long. Note Wallich's reference to inflation. These loans to poor and developing countries are closely related to the increased rate of inflation the entire world has suffered since 1970. Note Wallich's reference to "the financing of consumption-oriented oil imports." To use a helpful analogy with private business, it was as if the banks were lending people money to cover operating losses rather than for productive investment. To go back to our original example: It does make a difference whether the Italian bankers' money went to finance the wool trade or to finance wars. The one is a productive investment, the other is not. This is a major difference be-tween the great wave of international lending and investing that took place in the 19th century and the great wave that billowed up after the world was OPEC-ed in 1973. If Victorian Britain shipped its surplus savings to Argentina to build railroads, the railroads themselves could generate the income to service the loans. Not surprisingly, of the 87 foreign government loans of £1 million or more issued in London from 1860 to 1876, nearly half had maturities of terms from 100 years to perpetuity. But if an American bank lends Arab money to an African nation so that the African nation can burn oil, there is no productive investment generating cash to pay the interest. So much for those who say, "Why not just roll these loans over and over?" People will lend you long-term money to buy a house or build a factory. But who would give you a 25-year loan for a big party you want to throw tomorrow? Granted that many of today's loans are hardly self-liquidating, most people assume the governments would not let their banks sink even if a number of poorer countries defaulted; the governments or their central banks would take over the bad loans. If so, they might feed the flames of domestic inflation. There is also no guarantee of when, how and on what terms the government would intervene. In the 1932 presidential campaign, Franklin D. Roosevelt promised that, if elected, he would

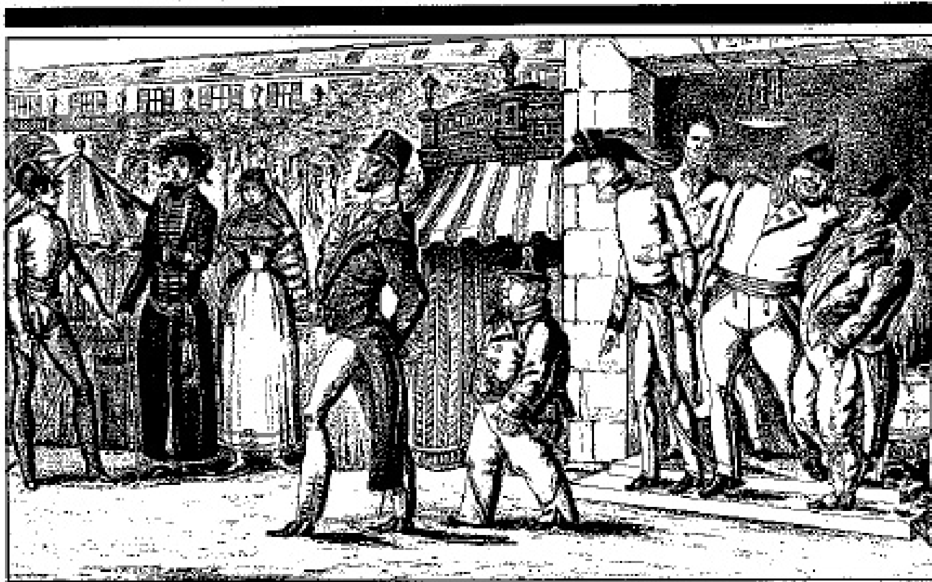
Too much of a good thing?

Below, the enormous growth of monetary reserves held by the central banking authorities of all countries reporting to the International Monetary Fund—most of the Free World. Foreign exchange and gold are the biggest components of monetary reserves, as defined by the IMF. (There are two others: Lines of credit with the IMF and Special Drawing Rights, an IMF currency unit.) Central bankers like to value their gold at a constant price, usually SDR 35 per ounce. But if the gold component is accorded its current *market* value, total monetary reserves have grown to a potentially explosive degree.



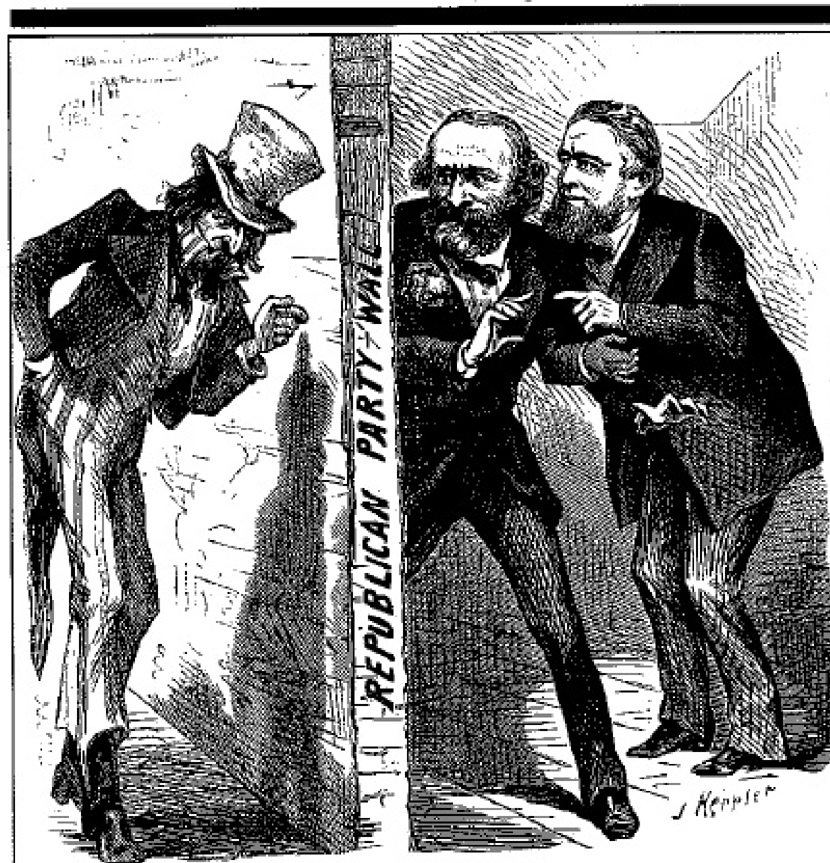
Source: International Monetary Fund

make sure that "it will no longer be possible for international bankers or others to sell foreign securi-ties to the investing public of America on the implied understanding that these securities have been passed on or ap-proved by the State Department or any other agency of the government." The great surge of U.S. foregin lending in the late 1920s was triggered by the 1924 Dawes Plan. An earlier version of today's petrodollar recycling, it provided that a big loan would be floated in several countries to finance the continued payment of war reparations by Germany. The U.S. share of the Dawes loan, managed by J.P. Morgan & Co., was $110 million. It was oversubscribed 11 times. The public impression of broad U.S. government support for foreign lending was reinforced by the intimate dealings be-tween the State Department and New York banking houses during the U.S. military interventions in Central America and the Caribbean before 1930, when strong measures were taken to secure debt repayment by defaulting governments. But under Roosevelt, the U.S. government did not intervene. Many banks failed and many countries defaulted on their debts. These disasters were both cause and effect of the drying up of international lending after 1928 -- initially to divert funds into stock market speculation. MIT economist Charles Kindleberger blames the cutoff in international credit for triggering and fueling the Great Depression. We've learned a lot since then, yet once again the financial world is in the same peculiar situation as when the vic-torious allies were trying to extort war reparations from Germany.It couldn't be done except through a peculiar ar-rangement under which the winners kept the losers in the game by bankrolling them. That's what's happening today. The poor countries of the world are losing their shirts to OPEC but, through the foreign banks, OPEC and the industrial nations are trying to keep the poor countries in the game. But the bankers are beginning to bridle.



The British strut in Paris in 1814

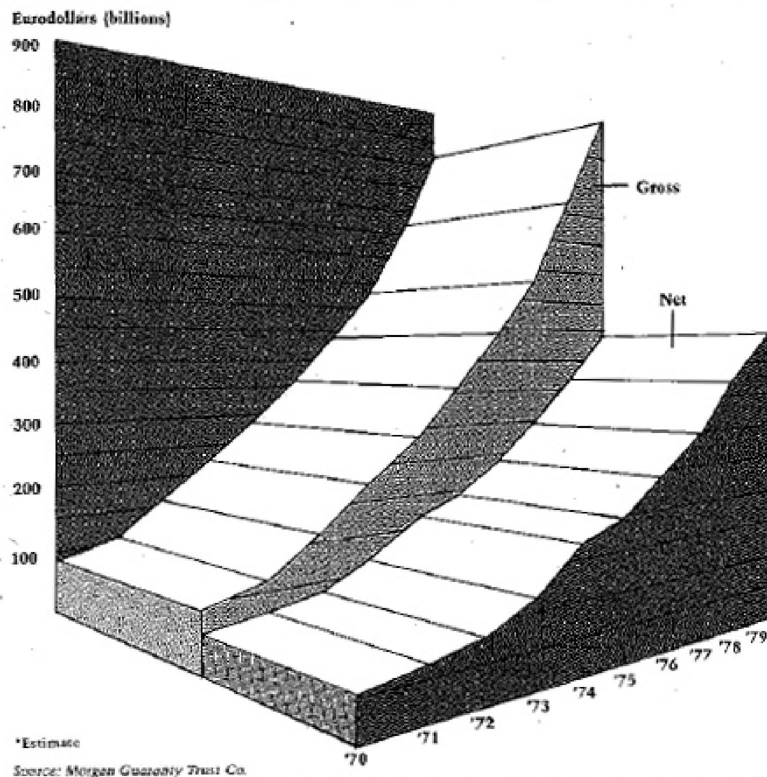
The British occupied Paris after the Napoleonic Wars and—as seen here through French eyes—acted as badly as conquerors tend to do. Britain's insistence on reparations then led the French to be equally hard on the Germans a century later.



Cartoon (1873) on Congressman Dawes and Vice President Colfax

Uncle Sam was not the only one who got no answer from the Credit Mobilier in the 1870s. Investors, many of them European, lost their shirts in one of the great financial-political scandals of its time, though it also helped build the U.S. rail network.

"The smaller and medium-size European and U.S. regional banks now are refusing to go into syndicated loans," says a German banker, Hans Berndt of Mannheim's Badische Kommunale Landesbank. "A year ago there were about 250 banks participating in international lending, while today there are only 60 or 80. This leaves the burden of lending to the giant banks, many of which are reaching their limits of lending to the countries that borrow most." German and Japanese banks have approached or exceeded lending limits to big borrowers like Brazil, and their governments are warning them to take it easy. German banks have been using Luxembourg, with its strict bank secrecy laws, as their "offshore" platform for launching the bulk of their $40 billion in outstanding loans to less-developed countries, but now their Luxembourg exposure is being consolidated into their general balance sheets in response to new German bank legislation. Like U.S. banks, German banks recently have taken a bed beating in the bond markets and also have incurred heavy losses by lending at relatively low fixed interest; their capital is getting stretched thin. As for the go-go Japanese banks, which alone generated two-fifths of the huge increase in Europmarket lending in 1977-78, their finance ministry has since cut their foreign lending to half the $1 billion monthly rate of recent years and imposed country loan limits of 20% of capital, which blocked further loans to such big customers as Brazil and Nigeria. Okay, you say. The banks may be in trouble. The poorer countries are in trouble.So, what's new? The govern-ments will bail them out. What has all this to do with my business, with my investments, with my plans to buy a new house or build a new factory? Just this: The whole situation poses an almost impossible choice for bankers, politicians and ordinary people. Because international lending is becoming excessively risky, the world must choose on the one hand between a dangerous slowdown in world economic activity and the danger of even faster inflation on the other. It is not a comfortable choice. It can lead to defaults in the courts and blood in the streets. We are accustomed to thinking of the post-World War II years as stormy, trying times, but in fact they witnessed an unprecedented expansion of international trade and a rise in the standard of living in almost every corner of the world -- except where the prosperity was swamped by runaway population growth. Until the Seventies began, this steady expan-sion was restrained by relatively limited liquidity. During the Fifties and Sixties the world's monetary reserves grew by 2.7% yearly, one-third as fast as the growth of world trade. There was continuing fear of a possible "dollar shortage" and of insufficient world liquidity to sustain international trade. This caused constant complaints from the poorer coun-tries who wanted easier credit, but it also helped to hold down inflation. This sober but basically sound situation was reversed dramatically in the 1970s. Suddenly inflation rates doubled over previous decades in the industrial countries.They tripled in the poorest lesser-developed countries (LDCs). Infla-tion rates quadrupled in the "middle income" LDCs, from whose ranks came the biggest international borrowers: Brazil, Iran, the Philippines, Nigeria, Korea, Algeria, Turkey, Mexico and Yugoslavia. Liquidity was no longer a problem, but inflation was. During the 1970s, the world's official reserves took a quantum jump, multiplying fivefold in current dollars, from $78 billion at



Loose billions

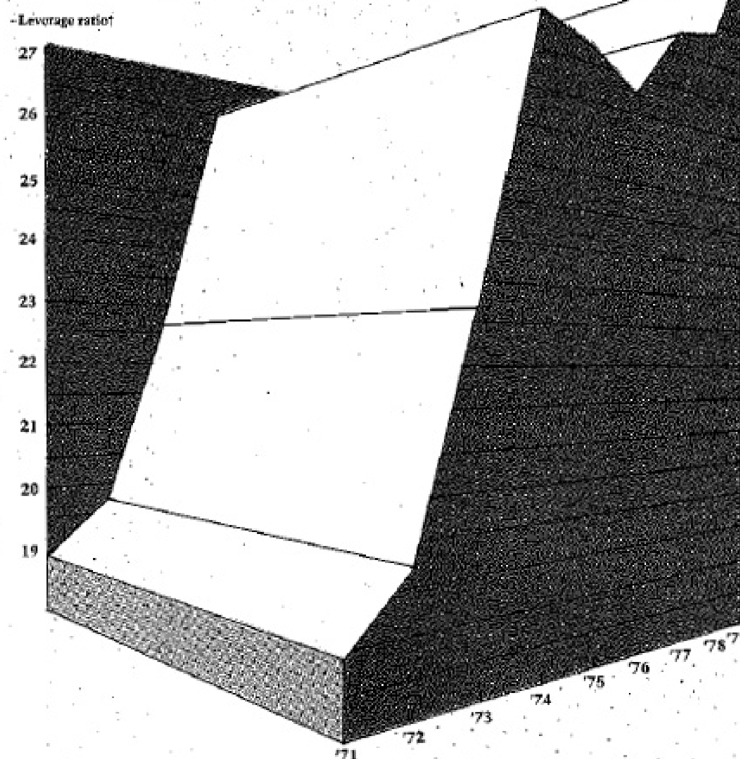
Created largely by U.S. deficit spending and by repeated OPEC price increases, dollar holdings overseas are 8 times as large as they were a mere decade ago, making the Eurodollar market the most important source of international credit. Euromarket lending is beyond the reach of regulators. The gross size of the market is approaching $1 trillion, but the net size (with interbank transactions subtracted, a truer measure) is awesome enough at $445 billion.

the end of 1969 to $398 billion by 1979 if central bank gold hoards are valued at the old official price of $35 an ounce. But they multiplied tenfold -- to $830 billion -- during the decade, if gold is valued at market prices. A large share of central bank reserves of foreign exchange earn interest as deposits in the Euromarkets, the central pool of international liquidity. Not surprisingly this market also has multiplied tenfold over the past decade to almost $1 tril-lion. The name of all this is easy money -- liquidity, in technical terms. We must go back four centuries to find anything comparable to the monetary expansion that took place during the 1970s, back to the influx of New World treasure into the European economy through Spain and Portugal. But the 16th-century money explosion occurred over a much longer time span than the current one. It took 160 years (1500-1660) for this treasure to triple Europe's stock of silver and increase the gold in circulation by one-fifth. Foreign merchants, bankers and artisans besieged and invaded Spain and Portugal to siphon away this treasure by selling goods and ser-vices, just as foreigners tried to siphon away the OPEC surplus of the 1970s. The Spanish gold and silver bred inflation on the bad side and vast economic development on the good side. FORBES has explained this phenomenon at length (FORBES, Nov. 15, 1976 and Sept. 15, 1977). What gold and silver were to Spain, monopoly-priced oil is to OPEC. Since 1973, when OPEC rulers began holding the world to ransom, their currency reserves have increased sixfold. The attendant inflation has cut the value of those reserves, but using Morgan Guaranty's ratio for discounting inflation, OPEC's foreign assets of $224 billion in 1979 would have been worth only $68 billion in 1974. The oil users have, in effect, used inflation to partially insulate themselves from OPEC's greed. Drawing upon these OPEC surpluses either as deposits or as certificates of deposit, the commercial banks have gone on a lending spree, much of it to the poorer countries. And this is how the LDCs have been kept in the game. Tinker-to-Evers-to-Chance. Western Europe buys oil from OPEC. It them sells enough goods to the poorer countries to cover the deficit with OPEC. The poorer countries pay for Europe's goods with money borrowed from the commer-cial banks. The banks get the money from OPEC. This is called recycling. You could also call it a confidence game. In 1977 a panel of distinguished economists headed by the able Paul McCracken, former chairman of the U.S. Council of Economic Advisers, confirmed this. The panel reported that industrialized nations' "ability to reduce the [oil] deficit to levels below anticipated magnitudes depended partly on larger deficits in the nonoil-developing coun-tries.These were possible as a result of unprecedented increases in private lending to these countries, with private banks in OECD countries acting as turntables for OPEC surplus funds." According to International Monetary Fund calculations, there is a one-year lag between increases in the world's monetary reserves and expansion of the world money supply, and a 30-month lag before world reserve increases are felt in world inflation. By this rule of thumb, reserve increases taking

Charles G. Dawes (top left) *at a post-World War I reparations negotiation;* (below) *a wheelbarrow full of German marks in 1923*

Trying to squeeze 20 billion marks from defeated Germany soon led to virulent inflation there and an ingenious solution by the victors: Why not lend Germany the wherewithal to make the necessary reparations payments?

place in 1979-80 as a result of last year's and this year's stiff oil price increases will be felt in price rises during 1982-83. If this is correct, the current slowing of inflation will be temporary, reflecting the relatively flat trend in oil prices between 1975 and 1979. And perhaps the next burst of inflation will lead to yet another doubling of oil prices. The Euromarkets, where all this liquidity accumulates, had a humble beginnings. They were created in the 1950s as a modest haven for the dollar holdings of Soviet bloc countries against the possibility of a U.S. freeze of their depos-its, similar to what actually happened with last year's blocking of Iranian assets. Between 1964 and 1970, however, Euromarket holdings of dollars suddenly began to swell, growing from $17 billion to $90 billion in those six years. This was, of course, before OPEC had taken the bit in its teeth.What happened? Simply that the U.S. began running regular balance-of-payments deficits and at the same time U.S. Treasury regulations discouraged American companies from repatriating profits from overseas operations. These expatriate dollars settled in Europe, and the number of U.S. banks with branches and offices in London grew from 11 in 1963 to 60 by 1974. Like bees to honey, the U.S. banks went where the money was. Treasury regulations also made it more profitable for U.S. banks to keep deposits in overseas branches. In 1971 the U.S. payments deficit suddenly tripled to $30 billion, hugely increasing the dollar holdings of foreign banks. Again, according, to the McCracken Report on world inflation, the size of U.S. payments deficits over the pe-riod effectively removed balance-of-payments constraints in other OECD countries and facilitated a massive expansion of money supplies. The McCracken Report calls this explosion "the most important mishap in recent economic policy history." Suddenly, nobody was short of money. That may be a good thing for individuals. It isn't good for a world where there are only so many goods and services available. Until 1973 the main source of such new reserves was the U.S. payments deficits. But after the 1973-74 OPEC price increases, OPEC became the leading supplier of outside funds -- sucking the money out of oil users. Instead of only one powerful machine dumping liquidity into the system, suddenly there were two. There is, moreover, an extraordinary multiplier at work in the Euromarkets. Because they are unregulated and free from reserve requirements, they are not dependent on new deposits to generate additional lendable funds. How fast the system could spin and create new money like cotton candy was demonstrated in 1978, the year of greatest Euromarket growth up to that time, when the amount of money in its accounts expanded by $140 billion to $662 billion. In that year, loans to nonoil LCDs doubled to $26.9 billion. Easy come, easy go.In 1978, for example, Brazil increased its borrowing from $2.8 billion in 1977 to $5.6 billion; Korea, from $1.3 billion to $2.7 billion; the Philippines, from $700 million to $2.1 billion; Algeria, from $723 million to $2.6 billion. As a result of this new borrowing, central bank reserves in Latin America, for example, expanded by one-third dur-ing 1978, contributing to a rise in the region's general inflation rate from 40% in 1978 to 47% in 1979. Give people money to spend and they will spend it. There is no mystery as to why inflation took off in the 1970s. Will the acceleration of economic development launched during the monetary explosion of the 16th and 17th



Forbes, June 23, 1980

centu-ries now come to an end as the money explosion of the 1970s and 1980s slows? For slow it must. Slowing it already is. This question is hard to come to grips with because of the gossamer forms that money has assumed during its rapid expansion, assuming new identities daily. It can be in the form of metallic commodities, paper currencies, proliferating credit schemes or items of electronic accounting on international computer networks. Lord Armstrong, chairman of Britain's Midland Bank, is a retired civil servant who is fascinated by money's chang-ing forms. "It's such a marvelous thing," he says. "If you imagine it beginning with cattle, or cowrie shells, or gold, and think where it is now, as metaphysical as a tap on a telex, or a click on a tiny computer, and yet basically the concept is the same thing. It is one of the most precious facts in the world, if you try to control money in one place, it gets uncon-trolled in another. Liquidity is the word that is applied to it, but it is much more than that. It is gaseous rather than liquid. That is what makes it such a fascinating human invention, such an expression of freedom in a strange way, be-cause it is literally uncontrollable. And yet it is like fire: You must prevent it from getting out of hand." Money in recent months came close to bursting into flame. In late 1979 and early 1980 the value of the world's monetary reserves careened from month to month like a roller coaster as speculators shuttled back and forth between gold, commodities and the dollar. According to IMF statistics based on current gold prices, the value of world reserves jumped by 11.6% in one month (September 1979). It contracted slightly last October, after the U.S. Federal Reserve jacked up dollar interest rates. It surged again by 13.5% in December and 16.4% in January after the seizure of U.S. hostages in Iran, the U.S. freeze of Iranian assets and the Soviet invasion of Afghanistan. Then the price of gold peaked at $8.50 per ounce in mid-January; the commodity markets collapsed; silver crashed; and interest rates began their descent, bringing a tidal wave of funds into the Euro-markets and forcing down the London Interbank-offered rate, the floating baseline interest rate for international lending. From nearly 20% in mid-April it fell to around 10% in May -- to the great relief of U.S. corporate borrowers and of debt-ridden countries like Brazil. Right now the situation is relatively quiet, but the international financial crisis is by no means over. "Brazil illustrates the economic risks faced by U.S. banks," James H. Gipson, formerly of Boston's Batterymarch Financial Corp., warned recently. His was a rare public statement of a view that bankers usually express only in private. "To avoid a catastrophic default by so large a borrower, U.S. banks have no choice but to roll over their old loans and to make large new ones [to cover continuing payment deficits]. The real risk in foreign loans is a once-in-a-lifetime wave of defaults by many borrowers at the same time, an event that would render many large banks insolvent." Shades of the Medicis, of Baring Brothers, of the Dawes loans. Until recently Brazil was the darling of the international financial community, because of the economic "miracle" of 1968-74, when Brazil's gross national product grew by an annual average of 10%.Brazil borrowed aggressively, doubling its foreign debt every three years since 1968. In sense, in flation was Brazil's best friend. Some economists calculate that, with world inflation averaging 12.5% yearly since 1973, the real cost of amortization and interest on an eight-year Eurodollar loan made in 1970 with a three-year grace period would be half its original value. The Brazilians were paying their creditors in 50-cent dollars while their creditors were pressing more dollars on them! But today foreign bankers are down on Brazil, almost to a man. This turn-about illustrates why the game may be ending, why the winners of the money are no longer willing to stake the losers. The bankers are down on Brazil

The U.S. hostages in Iran

The hostage crisis became a banking crisis after President Carter froze Iranian assets here last November. Most of Iran's $8.1 billion in foreign assets were in U.S. banks, but foreign banks held 70% of Iran's $8.9 billion foreign bank debt.

Forbes, June 23, 1980

because Brazil seems headed for a midyear crisis, with inflation running at 87% for the past 12 months and likely to reach 100% by July if present trends continue. This year Brazil's payments for oil and debt service alone will be roughly one-fifth greater than the government's $20 billion export target. In January 1979 Brazil's $12 billion in borrowed reserves were worth nearly a year's imports, but since then Brazil's import bill has dou-bled. Those reserves are being drawn down fast and could be down to three months of today's imports unless Brazil borrows more money very soon. Last month the Bank of Montreal, the world's fifth-ranking loan syndicator, ran into a stone wall. It was trying to recruit banks to take pieces of a $350 million loan for Brazil's National Economic Development Bank, the world's larg-est government development bank and previously a prized customer of foreign banks. The poor response to the loan was especially embarrassing at a time when Euromarkets were being flooded with new money and London Interbank-of-fered rates had dropped from nearly 20% to 11% over a three-week period. In trying to sell the loan, the Bank of Montreal offered to sacrifice its own management fee and keep $125 million of the exposure for itself. Upon receiving an invitation to participate, Japanese banks consulted their finance ministry, which not only vetoed involvement in the Brazil loan but also warned that Japan's new country-risk limits would impede most of its banks from joining new Bra-zil syndications for the rest of 1980. Now Brazil and the world's major banks, not knowing what to do, circle cautiously like two dozen prizefighters tossed into the ring by some absentminded promoter. Nobody wanted to cause a general panic by striking the first blow, and nobody wanted to leave the ring alone to face the confusion in the noisy arena beyond the klieg lights and the smoke. While Brazil and the bankers were eyeing each other in early 1980, many smaller developing economies were fal-ling into much more desperate financial straits. They include: Turkey, the Philippines, Thailand, Korea, Sudan, Poland, Pakistan, Nicaragua, Panama, Egypt, Jamaica, Zaire, Ethiopia, Kenya, Morocco and Yugoslavia. Last year the volume of lending by commercial banks to non-OPEC developing countries expanded by nearly one-third, to $35 billion, with the bulk of this money being provided by 12 banks in Germany, Japan and the U.S., plus the Bank of Montreal. Prudence says the banks should pull bank. But banks are not ordinary private businesses, and the economic viability of several of these countries is important strategically, in one way or another, to the major Western powers. Who will make the next move? Several debt renegotiations already are under way.Small cases, not highly politicized, can be hundled easily. For example, Togo, a little African state whose per capita income declined by 4.1% annually during the 1970s, was able to reschedule $100 million in debts quickly this year.On the other hand, Nicaragua is demanding rescheduling of $490 million in commercial bank debt, plus $100 million in interest arrears, over 25 years at 7% flat interest, in a package that would include a seven-year initial grace period. Is that all the country's new rulers want? Oh, no. They also want a substantial net inflow of new loans as well. After President Tito's death, Yugoslavia again is expected to play a volatile role in East-West power politics. Its foreign debt expanded from $1.6 billion in 1972 to nearly $13 billion today, even as exports stagnated and as Yugoslavs working abroad were sent home, cutting off an important source of income for the country. To keep Yugoslavia from being absorbed into the Soviet bloc, Western governments will probably have to finance its foreign debt. Such a bailout is now going on in Turkey, the economically prostrate member of the North Atlantic Treaty Organi-zation. A $1.1 billion concessional loan package has been put together by 16 Western governments for Turkey, but Turkish negotiators in Paris have been saying they need $3 billion in 1980. German banks have been heavily involved in intensive debt renegotiations with Poland, the largest debtor among Soviet-bloc countries. Commenting on Poland's efforts to stretch out payments of $6.5 billion falling due in 1980 in its $19.5 billion hard-currency debts to foreign banks, one American banker was very frank: "We don't want to encourage the Poles to go back to the Russians for help. On the other hand, we don't want to play the heroes, especially with Bra-zil's debts handing over our heads." Financial crises aside, all this could have dire consequences for international trade, upon which millions of Ameri-can jobs depend. Apart from the small republics of Latin America and black Africa, the main countries now in debt trouble are the high-growth economies of the Seventies: Brazil, Poland, Turkey, Korea, Thailand and the Philippines. Good customers of the U.S., all of them. Can they continue to trade with the U.S. at the current rate, if U.S. banks can no longer finance the oil imports needed to keep their economies growing

as fast as they did in the 1970s? The big banks and the monetary authorities of the U.S., Europe and Japan are groping their way toward a restruc-turing of international lending mechanisms. They are awed by the prospective task of managing the enormous increase in the petrodollars expected to flow through the world's monetary system in the Eighties. The less-developed countries are being pushed in the direction of the International monetary Fund in order to prevent them from putting too much stress on commercial banks. Morgan Guaranty's senior vice president of international economics Rimmer deVries is one of international bank-ing's most respected economists. He chooses his words carefully: "Greater direct lending by OPEC surplus countries to nations in deficit, the IMF substitution account and the provision of off-market diversification facilities all can play a useful role in lessening the economic and financial risks overshadowing the next few years." Don't be put off by the cautious words. DeVries is sounding the alarm. How much help can he expect? The International Monetary Fund has about $30 billion available for lending to member countries, which is ex-pected to expand substantially when a 50% increase in national quotas, soon to be approved, becomes effective this year. In early 1980 the IMF loaned $850 million to South Korea and $659 million to the Philippines. It joined in the Turkey bailout and may grant a large credit to Egypt. But how far can even $45 billion go? And how long can the world depend upon the unregulated, free-wheeling Euromarkets to decide the fate of nations? At the April meeting of the Bank of International Settlements in Basel, the world's central bank governors issued a stiff warning about the dangers of unsupervised Euromarkets to the international banking system. Both the U.S. Federal Reserve and the Bundesbank have been seeking some kind of international control over Eu-romarkets, but this has been resisted by the Bank of England. The British like the idea of having hundreds of foreign bank branches creating many jobs and reviving London's former grandeur as the world's leading financial center. The British government has been so keen on reserving bank jobs for its own citizens that it has been denying work permits to senior executives of foreign banks to manage their London branches. But more recently, it has been reported that the Bank of England is in the process of changing its mind about controlling Euromarket lending. While U.S. and German central bankers agree about controlling the Euromarkets, they are at odds about the ur-gency of the need to find a substitute for the dollar as the world's sole reserve currency; the Germans don't want their mark to share this role. The dollar's recent show of strength enabled the industrial countries to avoid a drawl over this issue at the Hamburg meeting in April of the IMF Interim Committee. Discussion was postponed on the proposed IMF Substitution Account, an attempt to soak up the hundreds of billions of dollars floating loosely around the world. In-stead, the IMF staff was ordered to go to OPEC countries to borrow surplus petrodollars for recycling to deficit coun-tries. But the dollar problem won't go away. The dollar is likely to come under pressure as U.S. interest rates fall. What if the dollar turns weak again, as it probably will? If it does, there will be a gnashing of teeth in Washington and in European and OPEC capitals but a chorus of cheers elsewhere. This is because the U.S. can't solve its balance of pay-ments problems without hurting world trade. A cheap money lobby, something like the U.S. Greenback movement of the 19th century, is forming among LDCs. A trade boom, even if fueled by inflation, is their only hope for increasing exports in the short term and for getting new loans to pay off old loans and to buy oil. The LDCs are criticizing the IMF Substitution Account plan. After the IMF meeting in Hamburg stalled on the plan, Brazilian Finance Minister Ernane Galveas claimed a victory for his and other developing nations. The participating countries, he said, had recognized that "recycling dollars had priority over the IMF Substitution Account." Manuel Moreyra, president of Peru's Central Bank, has become one of Latin America's more respected monetary officials for his key role in transforming Peru from an international financial pariah into an object of avid courtship by bankers. "The world is entering a period of deepening financial problems," he says. "The old Bretton Woods system, based on the dollar, may have had its deficiencies, but at least it was a system. It worked for 26 years after World War II, while both international trade and the world economy grew very fast. Now we have no system at all. The present floating exchange rate system is a complete failure. There is no mechanism for disciplining either surplus or deficit countries . . ." David Rockefeller in a FORBES interview (June 9) mentioned that the OPEC countries themselves were beginning to share some of the burden. Because they are now handling an increasing share of the oil formerly channeled through the Seven Sisters international oil

companies, they are beginning to give direct credits. This will certainly help, but OPEC has never shown signs of being a charitable institution and, with a few exceptions like Kuwait and Saudi Arabia, its members need all the dollars they can get: IOUs from Jamaica, say, or the Sudan won't pay for machinery from Germany or wheat from the U.S. The LDCs realize this and continue to pray that international liquidity will remain swollen so that they can continue to borrow easily and, ultimately, cheaply. At the moment the world faces two equally grim scenarios: Scenario one: Lending will continue to dwindle, and there will be defaults from which the various governments will have to rescue their banks. The poor countries will no longer be able to buy goods from the industrial countries, which, in turn, will suffer depressed economies and lack the means to pay OPEC. The entire world economy will sink into low gear. The poor will starve. The rich countries will stagnate. Even the Communists will have nothing to cheer about. The U.S.S.R. and Eastern Europe depend heavily on world trade, and all seek cheap credits. Scenario two: The merry-go-round will speed up again. OPEC will continue raising oil prices. The politicians, unwilling or unable to impose austerity on the industrial countries, will encourage the banks to provide plenty of liquid-ity both for their own economies as well as for those of the poorer countries; and inflation will move up another notch or two. For a while the faster inflation will enable the poor countries to handle the debts they constantly incur because they will be servicing the debt with dollars that are constantly shrinking.But the faster inflation, with its attendant dis-ruptions, will end up by paralyzing the international capital flows upon which everybody's trade and prosperity depend. There is, of course, a way out. With a strengthened IMF, the nations might gradually accept a painful but bearable slowdown in their economies while the money supply is brought under control. This is probably the only way out. What are the prospects for such unity of action? Would the French wheat farmer and the U.S. steelworker, the Za-irean copper miner, the German autoworker and the Arab oil sheikh willingly accept what seem to be banker-imposed sacrifices to help reestablish world financial stability?Would they reelect politicians who tried to impose such sacri-fices? Could the governments of nations like Turkey and Brazil even survive the imposition of such sacrifices? To ask the question is almost to answer it. Yet without a slowing of world economic growth, without a partial drying up of international liquidity, even worse consequences loom. We are in the midst of an international financial crisis so arcane that it rarely makes the headlines or the evening news.It is going to last for a long time and have unforeseeable consequences. The money explosion started by the Span-ish silver galleons went on for 160 years and changed the world.

Forbes, June 23, 1980