Gene Rotberg looks like a less craggy, smoother version of another Gene--the actor Gene Hackman, star of the "French Connection." This gusty, rainy day of the meeting, the park outside the St. Moritz Hotel's window looked bleak and forlorn, and spring a long time away. Gene wore a striped grey flannel suit, and spoke in a driving emphatic style without a prepared text. This note summarizes some of the points. His subject: inflation, the state of the economy, recent financial, social and political developments in Europe, oil and Petrodollar matters.

It's oil that's typically blamed for the big increase in the cost of living, here and abroad. The increase in the price of oil isn't the only culprit, Gene Rotberg began. First, some fault must lie with "the expansionist economies of the Sixties and Seventies. This created and reflected a great demand for capital. The growth rates in Europe of 6 per cent a year were not sustainable." The result was pressure on interest rates and increased credit, which drove up the prices of goods and services.

A second cause of inflation was a basic shift in the demand and supply of raw materials. The increase in worldwide demand permitted suppliers of items like soybeans, rubber, copper, zinc or sugar, to raise prices two to four hundred per cent in four to five years. This was reflected in higher costs for food and finished goods. Many of the basic raw material suppliers are in the underdeveloped world; some felt they'd been unfairly exploited since time immemorial by industrial powers. Coincident with the surge in raw material prices, "there was some expropriation - and considerable debate about the reasonableness of compensation - as the political ties with developed countries began to break down," he said.

A third factor was the weather and natural forces--principally the 1973 drought, and worldwide crop failures. As a result, China and the Soviet Union went into the world food market as buyers - which also contributed to price pressures on food. So, also, was the world's sudden lack of protein, "due to some mysterious movements of fish off the coast of Latin America." A fourth, and related factor, was the increased overall demand for food and the grain to feed animals and the cost of fertilizer.

Fifthly, the role of governments exacerbated the inflationary problem. Gene mentioned the U.S., "which did not finance the Vietnam war either by reduced consumption or increased taxation." Other countries also permitted considerable expansion of credit through fiscal and monetary policy.

Inflation was also stimulated by the growth of the export markets from Japan, Germany, France, Italy. This caused an accumulation of dollars in their Central Banks, which in turn resulted in increased domestic credit in their banking systems. Then there was the effect of spiraling labor costs. "As a political matter, in virtually every industrialized country, labor decided to increase wages--typically through built-in cost of living escalator clauses. In Japan and the United Kingdom and elsewhere labor groups wanted a larger piece of the GNP."

Finally, last December the price of oil went from below $2.00 to $9.50 a barrel and since then higher. This, added to the aforementioned forces and trends which were building up in the Sixties, laid the base for record-high inflation and, in part, for the recessionary effects that shortly followed because of a perceived decline in discretionary savings.

Gene then sought to analyze certain aspects of the contribution of oil to the inflation experience and to the financial markets in general. In 1973, the cash revenues going to OPEC countries was $22 billion. In 1974, despite the effects of the embargo on oil deliveries, the accumulation was about $100 billion. For calendar 1974, the surplus of their exports over imports (which were about $40 billion) amounted to $60 billion. By 1979, it is estimated by various sources that this surplus will total around $200 billion to $250 billion in terms of 1974 dollars. And if there is a $250 surplus for OPEC, someone has to have the $250 billion deficit.

That was the first set of points Rotberg emphasized. Secondly, oil is an essential raw material, in finite and scarce supply - controlled by countries that are politically independent - and for which there is no foreseeable substitute in the immediate future.

Third, most of the West can't reduce oil consumption without immediate domestic economic consequences. At the same time, most OPEC states "can't spend the resources that they receive for oil, because their economies can't easily absorb or create vehicles for these expenditures." To be sure, Iran, Indonesia, Venezuela and Nigeria, etc. have populations that over time will make absorption easier than, say, Saudi Arabia. But Rotberg believes that the leaders even of the more populous countries will be cautious about importing manufactured goods from industrialized nations, or importing traditional consumer goods--because too fast a rate of imports could create substantial allocation problems. And it takes time and expertise to build industrialized societies.

These surpluses seeking a home will trend toward the safest and most liquid investments pending their ultimate use. "This creates a problem for the poorest half of the population of the world. Major problems will be faced by countries who are not deemed creditworthy - the poorest countries in the world . . . because the OPEC countries aren't going to put their deposits in less developed countries . . . of the $57 billion invested last year by OPEC, 90 per cent was in dollars and sterling, and the balance in yen, DM, French franc and Dutch guilders." They will, however, make direct loans to some of the less developed countries and have made substantial contributions to the World Bank--which, in turn, will relend to the poorer countries.

Faced with the lack of resources to pay for oil, the underdeveloped world attempts to 1) cut imports, 2) consume less food, 3) consume less oil, 4) have steep currency devaluations and/or 5) borrow directly from OPEC. "Imagine that you were the heads of States with a population of one billion people; you can't pay for oil and you must have food and energy. Perhaps you can borrow some of your requirements from the IMF or the World Bank. You can't participate in the "Solidarity Fund," because that membership essentially is limited to industrialized countries. Your lines of credit with Banks are quite limited or non-existent. What would you do? You go to the OPEC nations and ask them to lend you the money; this will mean 'major changes in the world balance of power.'"

There is a further problem for the less developed countries--a decline in the prices of some basic commodities. "A good deal of the improvement in the U.S. consumer price index can be directly traced to a drop in basic commodity prices," said Rotberg.

Having sketched this background, Rotberg focused on the financial recycling problem. "What happened to the banks last summer? There was all that talk and worry that countries would be driven to bankruptcy, because oil funds would be "withdrawn" and buried in the desert somewhere . . . . Much of the talk reflected an overreaction to severe inflation and increasing signs of serious recession.

There are only two ways for money to disappear: burying it or burning it--which would mean that OPEC were not effectively getting the increase in the price of oil - an untenable scenario. Or, redepositing the revenues back in the bank. The Central Banks of the World determine the money supply, not the identity of the deposits of the owners.

When an oil exporter gets a check for oil drawn on, say, Chase Manhattan, for instance, they deposit it somewhere. "The money supply does not change," Rotberg emphasized since the check drew down a deposit or borrowing of the importer. Nor does the OPEC deposit affect interest rates. If, for example, an oil importer borrows to pay for oil, this tends to push up interest rates; but the deposit made by the OPEC country then drives interest rates down. Rotberg emphasized the implications several times. "Oil payments don't affect the money supply, or interest rates. They do affect credit expansion to the extent deposits are made in London. The problem essentially is one of allocating the resources in countries which have the deposits, in response to the inflationary or recessionary problems facing the country or providing a market environment for investments of the deposits.

This point was somewhat obscured by surface events last year. When the oil payments were made, in the spring, after the oil embargo,

~~after the oil embargo~~, the recipients deposited these funds with banks in London. "This was a device to place this money under the protection of the U.K." The banks, in turn, lent this money through Eurocredit loans - often to oil deficit countries. At the time, however, there were very tight spreads among the banks, who were competing intensely with one another to put this money to work. There was, apparently, not excessive concern over creditworthiness or profit margins. Most OPEC deposits were for one month or a lesser maturity but the banks lent on longer terms - usually for six months before interest rate adjustments. "One bright day they woke up to the realization that this was somewhat inadequate; many lost money as interest costs on the roll over of deposits escalated." The problem was intensified when certain governments called back their deposits from banks and some banks, faced with a liquidity squeeze for money, were forced to bid up for funds. Thirdly, some unauthorized trading took place in currencies. ("It was a combination of an Ira Haupt/block trading syndrome - highly leveraged, substantial overnight positions.")

Toward the end of the summer, a few bank failures were highly publicized. The banks began to tighten up on loans. "By the fall they were no longer functioning as large recyclers of OPEC money, and in the third quarter money started to be deposited, in increasing amounts, directly with parent banks in the U.S.

It was a severe test, which was successfully met, of the banking system, according to Rotberg. As the deposits moved out of Europe, this forced borrowers to seek direct loans in New York, or more recently to borrow in U.S. capital markets. One consequence that Rotberg saw was a revival of New York as a center of international capital. He noted that recently the government of Mexico,

the Japan Development Bank and a French government instrumentality had floated note or bond issues in New York. These were bought, he assumed, by banks who were seeking a return on their resources in the face of a declining business loan demand. "This means that Western Europe is now looking to the U.S. as the source of closing their oil payments deficit."

Okay, but that still doesn't get to the heart of the matter. Side by side with these recycling developments. Rotberg expects more direct loans between buyers and sellers of oil. But at some point OPEC may decide that it has lent enough to one country, and U.S. institutions, who don't understand foreign issues anyway, can't be expected to be the supplier of credit. The Banks feel there may be too much credit risk - with too narrow spreads and better alternative investments.

What does the would-be borrower do? He may start to try and earn foreign exchange by putting up trade barriers and trade restrictions and at the same time maximize exports. Everyone soon ends up with the same strategy, which is self-defeating for all.

"Now if you are a responsible U.S. government official, you will be concerned. Why? Because you know that a good many of the Fortune 500 companies sell ~~a~~ substantial ~~lot of their~~ products abroad." Their production and viability can be affected by barriers to their exports." What might you recommend? You develop a "Solidarity Plan" so that some of the industrialized nations can have a facility or vehicle to borrow money for trade deficits. The U.S. tries to maintain free trade, and refrains from imposing trade restrictions on imports and hopefully convinces others to do the same.

However, at the same time, one also notices that, domestically, individual discretionary savings are down, partly because of inflation. "It doesn't take a genius to see that under these circumstances, people should spend more - consume more; the classic answer is a tax cut." Most countries facing this problem - a decline in consumption - can't easily do this. For how would the resulting deficit be financed? But the U.S. has an advantage: the OPEC deposits. "OPEC essentially finances the U.S. deficit through their bank deposits." The problem faced by the U.S. then is an old-fashioned and difficult one - how to allocate the tax cuts.

Weaving an admittedly broad brush, Rotberg quickly summarized his points. The industrialized State tries first to reduce oil consumption, and to cut unnecessary imports. It is made easier by a recession. There are also export drives, plus a redistribution of OPEC deficits through multilateral plans and organizations. The U.S. deficit is financed by OPEC.

There will be a loss of control to those who have wealth and who make that wealth available through credit deferred payments and grants. "Some countries which for two to three hundred years have been powerful may find this power diminished. With this, there will be a loss of ego and an awful lot of political strains in the world," Rotberg prophesied.

One of the potential strains for the developed West is that it will ship goods and services for consumption in OPEC. "Citizens in industrialized countries will work and produce goods for citizens of other countries. That's a 'loss' in one's standard of living, when what you produce is transported somewhere else - when there is a transfer of real goods and services from a country which previously consumed what it produced to

exporting what it produces." What's the answer to this problem? Why, that _is_ an answer. And the difficulty of accepting the change, causes some of the predicted social and political strains.

On this somewhat bleak note, Rotberg, a lawyer with a taste for advocacy, rested his case. Questioning began. To the first questioner Rotberg emphasized that, for the most part, the U.S. and the U.K. are now major repositories for OPEC surpluses. Other countries ~~like Switzerland~~ are concerned with such a prospect. "It's inflationary. Markets are thin and could put pressure on interest rates and the exchange rate. Some countries are afraid of direct investments from the outside," he said.

An Institute member asked for Gene's interpretation of the recent dollar weakness in world currency markets. "My view is that it's interest rate arbitrage," he replied. "If you can achieve 5-1/2 per cent on a U.S. Treasury Bill and 10 per cent for a yen or DM deposit, you may sell dollars and buy yen or DM. In early January, an investor could get 16 per cent on intermediate term, fixed interest, sterling investments. As the recessionary influences in Europe place more direct pressure on governments, credit should become easier, interest rates will decline, and the possibility for interest rate arbitrage, in the face of exchange risks, should diminish.

Another member wanted to know the significance of the recent Saudi Arabian action, disassociating their currency from the dollar. Three other OPEC nations did likewise. "The amount of dollars they receive for oil will be the same," Gene explained. "But when they import goods or services, they want to pay less riyals--so they have pegged the riyal to a basket of currencies--the SDR, rather than to the dollar."

Did he think that OPEC direct investment in the U.S. would be significant? No--emphatically. "What would it mean to have a piece of paper that says they 'own' an automobile company in Detroit? I don't think that dominating a particular U.S. company would appeal to you in their position. Put yourself in the position of an OPEC leader. What do you want to do with your surplus resources - assuming you will never "need" them in your own country? What do you want to do with yourself? You want to go down in history as somebody, who did good or great or difficult things--I assume that is what motivates someone with billions of dollars. You may also want to raise the standard of living of the disadvantaged and prove the value of your own society or civilization. Or maybe it would be exciting to build a bigger port than Rotterdam in the Middle East."

Gene is personally a cheerful advocate. However, his concluding thought was somber. He was asked the consequences of the rising political tensions that he predicted earlier. In general, he believed, they will involve countries which have been used to wide freedom, learning to submit to new external limitations. A particular problem area could be Western Europe. "Labor is strong. There is a not insubstantial class difference, and an awareness of it." This in turn could cause the eruption of discontent, particularly in a period of high inflation and rising unemployment. "Since the conditions don't appear viable for right wing movement i.e., support of industrial and military leaders by the young, and extreme nationalism - I assume the movements will be to the left."

At the conclusion, Gene Rotberg left many in his audience feeling they'd been on an exciting intellectual roller coaster ride.