<u>The Regulation of International Financial Markets from the 1950s to the 1990s</u>

Catherine R. Schenk

After 1945, the regulation of international financial markets became more intense and widespread as part of the system designed to avoid the chaos that had characterised international economic relations in the 1930s. This paper examines how the post-war consensus about the usefulness of regulating capital flows evolved after the advent of current account convertibility in 1959. First, an examination of the debate over regulating the Eurodollar market will be used to highlight the contrast between European attitudes to capital markets compared to the views of the USA and the UK, where the differences are not as firm or as reliable as has been portrayed. The archival evidence shows that there were lively concerns about the dangers of the market and vigorous internal discussion about intervention as well as regulation in both London and Washington, and also among banks themselves. Nevertheless, both American and British regulators resisted introducing controls because the benefits of the market for their balance of payments policies outweighed the threats. This is not to say that the British and Americans were opposed to capital controls per se. Indeed, this was a time of deliberate intensification of capital controls in the USA on US$ outflows, and in the UK on sterling transactions. This analysis shows that the traditional story that market innovation undermined the effectiveness of capital controls and therefore led to the collapse of the Bretton Woods system needs to be adjusted to take account of regulators' roles in allowing that innovation to spread, and how the US and UK deliberately used the market as part of their response to the imbalances in the international economy in the 1960s.

The next part of the paper develops the history of prudential regulation and supervision of international banking that began after the end of the Bretton Woods system. This area has remained a challenge for regulators for much the same reasons that were present in the 1970s: problems of enforcement, the privacy of banking business, and the primacy of national over international interests. A second theme of the paper, therefore, is the enduring conflict between the desire to have national sovereignty over financial markets on the one hand, and the need for supranational oversight to ensure consistency and enforcement of prudential supervision and regulation in an increasingly global market.

I

The regulation of international financial markets in the 1950s and 1960s was closely linked to the Bretton Woods solution to the 'trilemma' or 'impossible trinity', which explains that maintaining policy sovereignty in the context of fixed exchange rates requires imposing limits on international capital flows.[1] The over-riding goals of national economic growth and full employment as well as the development of welfare states after 1945 required that national sovereignty was prioritised over freer capital flows.[2] Countries with balance of payments deficits used direct controls on outflows to avoid relying solely on higher domestic interest rates. Conversely, countries with pressures for surplus and inflation used regulations to protect their domestic monetary systems from inflows of capital.

The terms of the Bretton Woods agreement reflected a broad international consensus that freer markets in goods were beneficial for growth, employment and incomes overall, but that international financial markets should be closely regulated.[3] While the link between freer trade and growth is fairly well established, there is still no such consensus for the link between liberalisation of financial markets and growth. It makes sense to assume that freer capital markets will generate a more efficient global allocation of investment resources and so provide the best prospects for growth. However, empirical research has revealed an ambiguous relationship between capital account liberalisation and economic growth.[4] Crafts has observed that there is 'no evidence that abolishing capital controls per se leads to higher growth….But there is quite good reason to believe that financial liberalisation significantly increases the risk of a subsequent financial/currency crisis.'[5] In 1997 the IMF began to consider including capital account liberalisation into its Articles of Agreement, but this process was stalled in the wake of the financial crises of the late 1990s. In December 2003 Anne Kreuger, Director of the IMF, advised that "Capital flows are, in some respects, like antibiotics. Anything capable of doing good is also powerful enough to inflict harm when wrongly used. That is not a reason to restrain capital flows, though, but to harness them so that they can do most good." [6] The history of international financial regulation is the history of the struggle to identify when capital flows were 'wrongly used' and the various 'harnesses' and their outcomes.

II

The persistence of global imbalances after current account convertibility led to greater reliance on capital controls as a tool to combat short-term balance of payments problems. In the UK, controls on a variety of financial and commercial transactions were intensified for balance of payments purposes during the 1960s. [7] On the other hand, the Bank of England allowed relatively free transactions denominated solely in foreign currency as part of the City of London's traditional business. This inconsistency eventually led to financial innovation that pierced the barrier between sterling and US$ transactions within the existing rules. In 1955 the Midland Bank began to offer higher interest for US$ denominated deposits that it then used to ease local liquidity constraints.[8] This innovation quickly spread and led to a resurgence in British merchant banking and also a rush of foreign banks opening offices in London to take part in the market.[9] Moorgate, where many US banks found premises, became known as 'America Avenue' and the Eurodollar market quickly moved from being dominated by British banks to one dominated by American banks in London.

The initial regulatory response to the innovation of the Eurodollar market in London was to allow the market to grow, although there were misgivings within the Bank of England and the Treasury over the potential liquidity and volatility of the market. The Bank of England imposed informal prudential supervision by requesting banks to report their monthly Eurodollar balances. Bankers were also warned personally to be cautious about the term structure and liquidity of their Eurodollar business.[10] The effectiveness of this traditional approach to supervision in the City of London relied on a close relationship between the Bank of England and individual bankers, and therefore became less sustainable as the market became dominated by American bankers less amenable to such 'moral suasion'.[11]

Rajan and Zingales explain the failure to regulate the Eurodollar market as follows: 'It was on British soil, but eventually, many of its players were American. So neither country could unilaterally close it down.'[12] It is clear from archival and contemporary accounts that it was not a lack of cooperation between Washington and London that made it impossible to close the market. Rather the benefits that the market generated for both parties stymied efforts by *European* regulators to close it down. If they had wanted to, the Bank of England could have eliminated the market in London unilaterally (in the way that European governments did) by prohibiting the payment of interest on non-resident deposits. A major obstacle to imposing new more formal controls in London was the desire to sustain the status of London as an international financial centre. As a report by the Bank of England stated in 1961, ‘however much we dislike hot money we cannot be international bankers and refuse to accept money.’[13] Another obstacle to London unilaterally closing the market was that it would merely be driven to other off-shore centres with even poorer supervisory systems than London.

Looking more closely, it is clear that the British regulators’ motives for supporting the Eurodollar market are rather more complicated than they are portrayed by Helleiner and Rajan and Zingales, whose explanations begin and end with the desire to support London as an international financial centre, or Burn, who sees Britain’s toleration of the market as the result of the incestuous relationship between the City and the Bank of England.[14] Certainly at the time it was believed that the international activities of the City generated prestige and current account earnings. On the other hand, the Treasury’s intensification of controls on many financial transactions in the late 1950s and through the 1960s shows that hurting the interests of the City was not an obstacle to imposing controls if they were deemed necessary for balance of payments purposes.[15] As Burn also notes, of more immediate importance was that the growth of the Eurodollar market generated a net inflow of US$ that helped reduce Britain’s persistent balance of payments deficits.[16] The fact that the dollars attracted by Midland Bank reduced the recorded fall in the UK's central reserves in June 1955 from $US56m to US$6m carried considerable weight in the Bank of England and the Treasury. In a time of balance of payments deficits, the UK did not want to introduce new controls on capital *inflows*.

In the US, capital controls on outflows were a major weapon in the battle to rectify the persistent balance of payments deficits of the 1960s. The government imposed a series of controls; the IET in 1963, Voluntary Foreign Credit Programme of 1965 and reserve requirements on banks in the US accepting funds from their branches abroad in 1969. These policies encouraged the operation of US banks in London and enhanced the demand for Eurodollar loans there to finance US MNCs and other international borrowers seeking dollar loans. The outcome of the different regulatory environments in the USA and the UK was a reallocation of international banking activity. Britain’s share of world banks’ foreign assets peaked in 1969 at 26% of the global total, while the share of the USA fell from 21% to less than 10% from 1966-69.

The US Treasury agreed with the Bank of England that there was no immediate need for external supervision or new regulation of the Eurodollar market in London.[17] Burn details the slow realization in the USA of the importance of the market and confusion over its impact the early 1960s.[18] The under-secretary of state for monetary affairs, Robert Roosa, told Parsons of the Bank of England early in 1963 that he ‘was certain that the Eurodollar market would continue to be a feature of the international financial situation. It was potentially a vehicle for instability but also an important part of liquidity’ at a time when the perceived shortage of international liquidity was an important pre-occupation.[19] In talks with US banks, Roosa

> reminded them that although there is no question of imposing exchange control, they should, in his words, ask themselves whether they are serving the national interest by participating in this sort of activity, which adds to the volume of short term capital outflow from the US. Mr. Roosa was not too optimistic about the outcome.[20]

Roosa was evidently not as confident about the prospects of moral suasion being exercised effectively in the New York market as the Bank of England was in London. However, in 1963 some major US and European banks did agree among themselves to restrict the inter-bank market and avoid 'pyramiding' of deposits because of fears over the market's stability.[21]

At the end of November 1963, a fraudulent food oil scam in the USA (dubbed the 'Great Salad Oil Flap' by *The Economist*) brought down the broker Ira Haupte and generated a series of defaults on Eurodollar loans. This sent a shock through the market and brought monetary authorities back to the question of regulation and supervision.[22] The increasing volume of short-term inter-bank flows raised the spectre of the financial crisis of the 1930s but, unlike the 1930s, this did not lead to a reversal of policy.[23] In London, the system of informal supervision continued. As Cromer told Holtrop of the BIS, 'if in an individual case it appeared to us that an unsound situation was developing, we would then discuss the matter with the bank in question'.[24] Governor Daane of the Fed worried about the possibility that 'unsound lending' might to lead to a chain of defaults that would cause a banking crisis similar to that of 1933.[25] He was reassured, however, by arguments that the Eurodollar market represented a small proportion of banks' total liquidity and that the market was sensitive to geographical concentration.[26] Like the Bank of England, the Fed used its contacts to obtain more information about the market by asking a small number of leading US corporations why and how they used the Eurodollar market, but they did not put any obstacles in the way of such transactions.[27]

Burn is critical of the late interest the Fed took in the Eurodollar market, noting that it was only in 1960 that they sought to gather intelligence about how the market worked in Europe.[28] The result of this study led them to become more hostile to the market and they considered ways to insulate the US from the Eurodollar market 'by prohibition or patriotic persuasion' or by altering incentives or reserve requirements. The main goal was to curtail the evasion of tight domestic monetary policy through the Eurodollar market. By 1967, they concluded that

a) 'Prohibition might stimulate innovation in methods of avoidance.
b) Efforts at persuasion might bring counter-productive psychological reactions.
c) It would not be sound policy to make what might have to be a permanent change in the framework of reserve requirements for transitory reasons'.[29]

If the Fed wanted to support an integrated world money market, they could not introduce new reserve requirements on foreign deposits of US banks abroad. On the other hand, reserve requirements would 'help us to manage domestic monetary policy effectively – and, incidentally, help simplify other people's management of their domestic and external monetary policies'. Two years later, the Fed opted for domestic priorities and in September 1969 imposed a 10% reserve requirement on net liabilities to foreign branches of US banks in excess of the average amounts outstanding in May 1969. This discouraged foreign branches of US banks from repatriating US$ to their head offices and thus undermining US tight money policy. The Fed estimated that 30% of foreign branch resources were used to supply parent offices in 1969 but that in 1970 this had reduced to 2.7%.[30]

At the beginning of 1968, the Fed Board considered injecting additional funds to the market through the Fed-BIS swap mechanism to hold down Eurodollar interest rates.[31] As part of this study, it was revealed that the Fed had intervened in the market in the recent past, but by 1968 most in the Fed were against any further action. In April, the Fed publicly acknowledged that the Eurobond market was an integral part of their balance of payments policy: 'It has always been clear that part of the required adjustment in international payments would have to come through increased

European financing of capital investment in Europe and elsewhere'.[32] In 1968 new issues of securities in foreign markets by US corporations soared to \$2.1b from \$US450m in 1967.[33] The US money supply was insulated from the market by reserve requirements in 1969 but offshore borrowing of US\$ by foreign companies was encouraged to ease the pressure on domestic capital markets.

Although taking steps to insulate the US economy, the USA did not push the Bank of England or UK Treasury to impose controls in London. Burn interprets the evidence that the US authorities were concerned by the market in the early 1960s to suggest that they were frustrated by British reluctance to curtail it, but it is not clear from his account what the US wanted Britain to do.[34] The official view was that the US economy was vulnerable to short term capital movements of many kinds including the Eurodollar market, and that this problem could not be contained effectively through further restrictions. On the plus side, the market had increased overseas borrowing of US\$, thus relaxing pressure on the New York market directly. By 1970, the view of the President's National Advisory Committee on International Monetary Affairs was that the market was a symptom rather than a cause of instability between national markets and that:

> 'it would not be possible to achieve tight controls on the access of US banks, companies, or investors to foreign short term financial markets (including the Eurodollar market).[35]

This section has examined the regulatory response of the supplier and the host of the Eurodollar market. The financial innovation had not been anticipated and reaction was slow in London. The cozy informal networks that had developed in London from the 19th century encouraged the Bank of England to continue to rely on personal contacts and 'moral suasion' despite the fact that the market was changing dramatically with the arrival of US banks. The US Fed was uncertain about the impact of the market on their balance of payments, but found London's facilities eased domestic pressure to relax capital controls and tight money. Both sets of regulators at this point also recognised that this innovation marked a new era of complexity in international finance that was no longer as amenable to national controls. Moreover, the Bank of England was clearly sensitive to the dangers of regulatory competition between international financial centres. The over-riding priority for both governments was minimising balance of payments deficits and the market had a role to play in this campaign on both sides of the Atlantic.

In continental Europe, the commitment to stable exchange rates strengthened during the 1960s because the process of European integration increased the opportunity costs of fluctuating rates. Germany, with its balance of payments surplus, was traditionally the most liberal regime, having abolished controls on outflows as early as 1957, but they reintroduced controls on inflows during the 1960s. Switzerland became among the most restrictive regimes to prevent the internationalisation of the Swiss franc. France began and ended the period more restrictive than many other European countries but had a brief period of liberalisation in 1968. The goal of monetary integration should have led to intra-European liberalisation, but in practice domestic monetary sovereignty reigned supreme and controls were maintained. Most countries operated a combination of reserve requirements on Eurodollar deposits and prohibition of interest on short-term foreign deposits. Obstfeld and Taylor note briefly that France and Italy tightened some controls after 1973 to retain exchange rate stability, but this does not fully capture the widespread affinity for capital controls in Europe.[36] The conflict between capital controls and the European integration project was not finally resolved until 1990 with the abandonment of remaining controls in favour of the creation of a single market. This finally signalled a new solution to the trilemma for Europe with the abandonment of policy sovereignty and the creation of a single European central bank. Despite monetary union, however, the abandonment of national policy sovereignty and institutional barriers to cross-border capital account transactions remains controversial. [37]

The relatively lax regulation of off-shore international finance in London prompted central bankers in Europe to urge London to impose controls on the Eurodollar market. These efforts foundered over the conflict between national sovereignty and international cooperation, the interests of London and Washington in the continuation of the market, the danger of pushing it to a less well supervised off-shore financial centre, and a lack of consensus over its impact on national and international economic systems. Efforts to improve transparency and supervision were stymied by the priority central banks gave to the privacy of their clients' business. It would take the 1982 LDC Debt Crisis for central banks and the banking community to begin to overcome this inhibition and start to embrace transparency, although obstacles to communication between national financial regulators continued to plague efforts at prudential supervision through the 1980s and 1990s.

The BIS was the ideal forum for this discussion. It used the market in its banking relations with member central banks, and it was a regular meeting place for central bankers away from their governments.[38] In June 1962 Guindey of the BIS sent a letter to member central banks suggesting a meeting of officials to discuss the market. The BIS observed that 'looked at strictly as a competitive phenomenon and as a service to both the lenders and borrowers who use it, the Eurodollar market would appear a useful development. Are there disadvantages or dangers which should be set on the other side of the ledger?' such as counteracting monetary policy, dangers of a liquidity crisis in the market, impact on forward exchange markets. They concluded with the question; 'is it right for the central banks to leave the Eurocurrency markets without supervision or management?'[39] The meeting of experts merely skated over these fundamental questions and concentrated instead on the exchange of statistics.[40]

Central bank governors met in December 1963, just after the Ira Haupte crisis and their views show a lack of detailed understanding combined with general suspicion of the market. Hayes of the USA worried about over-extension of credit to a few borrowers and 'inadequate checking between countries of the credit-worthiness of borrowers'. [41] He was still uncertain of the impact on the US balance of payments. Blessing noted that 'the Bundesbank was not concerned about the participation of the German commercial banks in the Eurodollar market'. He felt that the market had similar problems as for all short-term international credit 'but he felt that the Eurodollar market had encouraged foreign bankers to be less cautious than they would normally be in granting foreign credits'. Brunet of the Banque de France remarked that 'he could not say whether the market was good or bad but that the central banks were justified in regarding it with a certain amount of suspicion…On the other hand, he thought there was no necessity for rigid controls.'[42] Cromer of the Bank of England was unworried by the market. Summing up the discussion, Holtrop concluded that 'the general view seemed to be that there might be problems in connection with the Eurodollar market but that they were not essentially different from the problems that existed in relation to international short term capital movements in general'. The BIS initiative then focussed on the collection of statistics for the next couple of years.

After the Haupte affair, the Bank of England recommended that the BIS should collect and publish statistics of the geographical destination of Eurodollar loans for the 'general health of the Eurodollar market'.[43] This idea was not taken up since data were not easily available from banks. In February 1965 most central bank officials viewed publishing eurocurrency statistics as an inroad on the confidentiality of bank business, but the central bank governors nonetheless called for the experts to examine 'concrete possibilities of centralising on an international level information on bank credits to non-residents' to include eurodollar loans as well as other credits.[44] Such information was a necessary prerequisite to prudential supervision.

The experts duly met in April 1965 to discuss two possibilities, a genuine international risk centre, or merely the collection of national data without the formation of a new institution. France, Italy and Germany each had their own risk centres and believed that most legal and administrative differences in their approaches could be overcome to allow data to be communicated to a new international institution. But the other countries were opposed.[45] The British representative was adamant that British law did not permit the creation of such a centre. The Dutch also saw no scope for a new institution. Their central bank received information on use of credits by clients but this information was for exclusive use of the central bank. Sweden received no information officially and did not believe Swedish banks would cooperate. The Fed claimed to receive a lot of information from private banks but nothing on individual borrowers. US companies were so big they often went to more than one bank and it was natural to expect that the banks would exchange information, making any official institution redundant. Swiss banks refused even to exchange information amongst themselves, so there was no possibility of contributing to a risk centre. Given the general antipathy to the idea of a new institution, the experts agreed to recommend the less ambitious plan to report all external credits in foreign and domestic currency to the BIS along the lines of existing Eurodollar reporting.[46]

Multilateral regulation of the market resurfaced at the BIS at the beginning of 1971 after a reduction in US interest rates prompted a massive capital flow into Europe. A group of experts met in February to discuss the prospects for a more interventionist approach due to fears that the market was inflationary and interfered with domestic monetary policy. However, there was still no consensus that restrictions in the market were advisable.[47] The US and the UK were still the most opposed to intervention. Daane, of the Fed, argued along the lines of the NAC position quoted above that existing problems of the short-term capital market did not arise from the Eurodollar market alone. The US wanted the BIS to pursue a technical approach rather than developing policy. The US authorities, nevertheless, were not wary of exerting national controls on the market to contain its inflationary impact at home. From January 1971 the marginal reserve requirement on Eurodollar borrowings by US banks (Regulation D) was increased from 10% to 20%.

The British remained resistant to regulation, either collective or national. Hollom of the Bank of England stated he 'would be reluctant to say that the market would be much helped by placing restrictions on its activities. If they [the Bank of England] were to do that, they might drive the market into other channels' which would be even more difficult to monitor. On the other hand, Emminger of Bundesbank and Baffi of the Banca d'Italia both remarked on how the market interfered with the effectiveness of monetary policy and wanted to examine of how central banks could influence it collectively. Theron of the Banque de France and Hayami of the Bank of Japan both advised that they protected their markets from capital inflows through national exchange controls. Hay of Banque Nationale Suisse was the most certain of the inflationary impact, estimating the multiplier at 2.5 and complaining about the interference with domestic policy. However, he did not support regulation. Instead 'what was needed was an attempt to get at the root of the problem, i.e. the [deficit] position of the US'.

A consensus eventually emerged that the market was inflationary but since there was no agreement on controlling private banks' access to the market, the logical progression was to restrict central bank deposits.[48] At a meeting of experts in April 1971, the mood was irritable, with some resisting the constraints on central bank freedom that this would involve and others wondering if it was worthwhile since only the G10 banks would be bound by any such agreement. Morse, of the Bank of England, conceded that there were strong arguments against a permanent ban on central banks using the eurodollar market, however, he noted three rather despairing benefits from the G10 making a public statement pledging not to use the market for the time being: 'one was that they might influence some [other] European central banks and the other was that there was a lot of agitation going on for something to be done about the Eurodollar market and it might be a good idea, therefore to feed those who were calling for action with something. In addition, they would have at least something to say that they had been doing in their meetings'.[49] The G10's self-denying ordinance did not include the OPEC countries that were soon to flood the international capital markets with their surpluses. In 1974 the Committee of Twenty of the IMF also proposed limiting state use of the eurocurrency markets, but the proposal was never formally adopted.[50] The competitive returns in the form of liquidity and high interest rates were too tempting.

Having achieved a standstill on central bank deposits, the Standing Committee returned to the more thorny issue of regulating or restricting the eurodollar market, but here no consensus was reached.[51] Daane of the Fed argued that in terms of the international financial and monetary crisis, the Eurodollar market was not 'the villain of the piece'.[52] Emminger and Kessler, however, believed that the 1971 crisis made multilateral regulation of the Euromarkets even more pressing, Kessler going so far as to say that failure to deal with the problem would threaten the newly re-established pegged exchange rate system. The resulting report of the standing committee to the Governors in March 1972 reflected this disagreement about the depth of the problem and its possible solutions. The Governors deemed it too weak to serve as the basis of policy decisions and referred the question back to the committee.[53]

Acrimonious discussion continued for the next six months. McMahon of the Bank of England supported national approaches to the market, essentially endorsing the status quo of exchange controls on the Continent that benefited the City of London. Emminger argued that EEC members could not accept regulation on a purely national basis since they were concurrently discussing monetary union.[54] The EEC set up a Contact Group of national banking supervisors in 1972 to develop co-operation and to exchange information on banking supervision, but progress was slow. It was not until the end of 1977 that they published their First Directive to co-ordinate laws, regulations and administrative provisions of credit institutions. Meanwhile, at the BIS and at the IMF Germany advocated reserve requirements on Eurodollar deposits but the British reiterated that this would merely push the market to a more hospitable international financial centre.[55] US representatives remained preoccupied with official depositors and went so far as to challenge why so many central banks kept deposits with the BIS at all.[56]

At their meeting on 10 February 1973, amidst disarray in the financial markets, no consensus could be reached among officials. [57] In the end Larre, as chair, remarked that 'this was not a very propitious day for discussing the question of the regulation of the Eurocurrency market' given large flows of short-term capital that were mostly not Eurodollar flows. It was agreed that Larre should produce a mainly factual report in his own name for the Committee of 20 at the beginning of March 1973.[58]

The deliberations of the Eurocurrency Standing Committee revealed irreconcilable differences over how serious the market had affected domestic monetary policy and destabilised capital flows, and secondly what controls were necessary or feasible. At their meeting in May 1974, the Governors still could not agree on these issues and multilateral regulation was not achieved.

The case of the Eurodollar market showed that the complexity of international financial flows made it increasingly difficult to formulate effective regulatory responses. This was due to disputes about the economic impact of the new market as well as the challenge of enforcing any regulation given the complexity of the transactions involved. Moreover, the supervision of the market focussed attention on the conflict between the benefits of transparency and the costs to business of a loss of privacy. In 1974 floating exchange rates and the oil crisis added to the supervisory challenges of multinational banking and increasingly complex financial markets. Attention soon turned from regulating the Eurodollar market to promoting the stability of multinational banking generally.

III

With the advent of floating exchange rates, doubts about the soundness of many new small and medium-sized banks in the Eurodollar market prompted the emergence of a tiered interest rate structure in the spring and summer of 1974. [59] Small banks faced a liquidity squeeze as the market contracted, causing the failure of the Herstatt Bank.[60] The market panicked and the rate on three-month Eurodollar loans soared to an unprecedented 14% in mid-July. At the end of September the New York Reserve Bank had to take over the foreign exchange obligations of Franklin National Bank.[61] The contrast between the willingness of the Bundesbank to allow the failure of the Herstatt and the Fed's support of the Franklin highlighted the inconsistency of international practices of lender of last resort. The Bank of England took no responsibility for the solvency of subsidiaries of foreign banks in London and so the Israel-British Bank was allowed to fail in July 1974 with outstanding debts of £43m.[62]

Ten years after the American 'invasion' of the city of London, this crisis prompted efforts to co-ordinate lender of last resort facilities to international banks. In September, the Central Bank Governors of the G10 announced that, although detailed rules governing lender of last resort to the eurodollar market were not practical, the market should be reassured that 'means are available for that purpose and will be used if and when necessary'.[63] They also set up the Committee on Banking Regulations and Supervisory Practices in Basle, chaired first by George Blunden and then by Peter Cooke, both of the Bank of England, an institution notorious for its light regulatory hand.

While international regulation stalled, national regulatory changes went ahead. In the City, the Bank of England urged consortium banks to set out formally in letters to the Bank of England that their shareholders would agree to act as lenders of last resort. Foreign banks were asked similarly for commitments that they would support their UK subsidiaries, although these undertakings were not enforceable.[64] At the same time the Fed announced that it was ready to act as lender of last resort for member banks to protect them against abrupt withdrawal of petro-dollars or any other deposits. Together, these measures reassured the market and the tiered interest rate structure contracted early in 1975 as confidence returned.

Ten years earlier, similar crises in Europe related to the Eurodollar market had been contained through informal and ad hoc advice. By 1973/4 the volume of capital flows, greater public sensitivity to the interests of depositors, and UK membership of the EEC required a more formal response. In addition to the traditional personal meetings with individual bank officers, London banks had to make more detailed and continuous statistical reports to enhance prudential supervision. At the end of 1974, the Bank of England sent a letter to all banks in the City advising them to tighten up their internal control systems, particularly the control of foreign exchange operations by branches and subsidiaries overseas. This was the first time such a formal public instruction had been made. The Bank of England also required London's British Overseas Banks for the first time to report the activities of their overseas offices. Blunden noted that 'the reaction of most banks to our letter has suggested to us that we were right in judging that the banking community as a whole was ready for us to take this new line.' Blunden, nevertheless, promised 'our approach remains flexible, personal, progressive and participative.'[65]

The Basle Committee Concordat in 1975 set out the supervisory responsibility for multinational banks, concluding that solvency of foreign branches was 'essentially a matter for parent supervisory authorities', while foreign subsidiaries and joint ventures lay within the responsibility of the host authorities.[66] The subsequent recommendation of 1978 that solvency should be based on consolidated accounts put greater emphasis on parent authorities to ensure the collection and publication of this information. The Concordat was further amended in 1983 to emphasize the need for cooperation and communication between host and parent supervisory bodies, which was elaborated in recommendations in 1990. The collapse of BCCI led to renewed calls for supervision of multinational banks and the Concordat recommendations were formalised into minimum standards in 1992, but enforcement was still problematic. The 1992 amendments shifted responsibility back to the host to ensure that parent countries had adequate supervisory structures. Banks were to seek permission for cross border expansion from both host and parent regulators. These amendments further emphasized international information flows, but by 1996 the BIS recognised that information was not passing easily from some hosts (particularly off-shore financial centres) to the parent supervisory bodies.

The Basle Committee also considered how it could help with risk management, perhaps through central agencies that collected information on total liabilities of particular borrowers that could be accessed by potential lenders. As in the early 1970s, the problem of customer confidentiality and the different standards of disclosure among the various jurisdictions made this impossible.[67] Instead, the BIS reported quarterly data on countries' total external debt and from 1978 included maturity distribution on a half-yearly basis. From December the Bank of England published the consolidated exposure of banks in the UK. In May 1982 the Basle Committee finally agreed on guidelines on country-risk for banks to consider – just in time for the LDC debt crisis of that year.

The progress of these efforts at international co-ordination was limited by the problems that still confront those seeking to develop global financial standards; different political, legal and institutional structures of financial systems and an antipathy to harmonisation. As noted above, the EEC harmonisation programme, surely most suited to supranational co-ordination, made little progress in the 1970s. At the International Banking Summer School of 1977 Blunden expressed the Bank of England's dim view of such efforts.

> The banking system of a country is central to the management and efficiency of its economy; its supervision will inevitably be a jealously guarded national prerogative. Its subordination to an international authority is a highly unlikely development, which would require a degree of political commitment which neither exists nor is conceivable in the foreseeable future.[68]

After relatively smooth sailing from 1975-77, international bank lending surged again in 1978 and coincided with a run on the US$ in the second half of the year. Into this volatile environment the Iranian revolution sparked off the second oil crisis at the end of 1979. Bank lending as a proportion of LDC debt rose from 15% in 1970 to 27% in 1980, contributing to the Latin American Debt Crisis of 1982. The prudential regulation introduced in the 1970s proved inadequate to cope with these pressures, particularly on the assessment of country risk, and the transparency of syndicated lending.

At the end of 1987 the Basel Committee issued a consultative paper on capital adequacy with minimum standards for international banks. The focus of their deliberations reflected the major preoccupation at the time; sovereign default risk.[69] After six months of consultation the proposals were adopted with some minor changes and were implemented by many banking regulators by 1992. The failure of the Capital Adequacy Requirements to forestall the series of financial crises in the 1990s led to a reassessment of risk weightings, in particular since they had been designed mainly with sovereign risk in mind (since this was the problem of the 1980s) rather than risk of private borrowers (which was the case in the Asian Financial Crisis).[70] Basle II also tries to emphasise prudential supervision and better disclosure, partly due to the increased sensitivity to money-laundering in the wake of the US 'War on Terror'. These events renewed efforts by the BIS and the IMF, as well as national regulators, to target financial stability.[71] The focus remains, however, primarily on national application and enforcement, and the future application of Basle II remains uncertain for many nations.

IV

This analysis has highlighted the development of multilateral regulation and supervision of international financial markets by focussing on the Eurodollar market and multinational banking in the 1960s and 1970s as the most important financial innovations of this period. These cases reveal the longevity of current obstacles to cooperative international efforts. International finance has remained regulated on a national basis because of practical obstacles to information flows and the dangers of pushing markets to more fragile and poorly supervised off-shore centres, as well as an ideological lack of consensus over the costs and benefits of globalisation, and the perceived threat to national sovereignty. These obstacles to cooperation derive from the origins of late 20th century globalisation and were as apparent in the 1960s as they have been over the last decade. Efforts at cooperative or collaborative supervision and regulation are most commonly found after a crisis when an international event has threatened national financial systems. This has resulted in the focus of these new guidelines being backward looking and reactive rather than pro-active. Moreover, as each crisis recedes, so does the impetus for regulatory reform.

International finance became extraordinarily more complex and surged in volume relative to 'real' economies in the 1980s and 1990s. However, the seeds of the basic obstacle to cooperative efforts at prudential regulation were already apparent in this earlier era of financial innovation. These debates set the precedent for the priority of national over collective interest in the absence of clear evidence that globalisation threatened systemic failures. The global financial crisis of 2007-9 dramatically exposed the weaknesses of this approach to international financial regulation, although the responses to the crisis have also demonstrated how difficult these obstacles are to overcome.

[1] M Obstfeld and M Taylor, *Global capital markets: integration, crisis, and growth* (Cambridge, 2004).
[2] RG Rajan and L Zingales, 'The great reversals: the politics of financial development in the twentieth century', *Journal of Financial Economics*, 69, 2003, pp. 5-10. p. 38-9.
[3] RG Rajan and L Zingales, *Saving Capitalism from the Capitalists* (New York, 2003). p. 242-3.
[4] B Eichengreen and M Mussa, *Capital Account Liberalization; theoretical and practical aspects* (Washington, 1998). JP Agenor, 'Benefits and Costs of International Financial Integration: Theory and Facts', *World Economy***,** Aug 2003, Vol. 26 (8), pp. 1089-1119 for a recent review of the literature.
[5] N Crafts, 'Globalization and growth in the twentieth century', *IMF Working Papers* WP/00/44, 2000, p. 51. See also N Crafts, 'Globalisation and Economic Growth; a historical perspective', *World Economy* 27(1), 2004, pp. 45-58. For a similar conclusion see ES Prasad et al, *Effects of Financial Globalization on Developing Countries Some Empirical Evidence*, IMF Occasional Paper 220, 2003.
[6] Anne Kreuger, Director of IMF, 9 December 2003 Speech in Malaysia.
[7] As late as October 1968, the Labour government re-introduced the control on sterling financing of third party trade that they had imposed in 1957 and removed in 1959.
[8] CR Schenk, 'The Origins of the Eurodollar Market in London, 1955-1963', *Explorations in Economic History*, 35, April 1998, pp. 221-38.
[9] From 1965-71, 69 foreign banks opened branches in London, of which almost 40% were US banks. The assets of accepting houses increased from £955m in 1962 to £3587m in 1970. CR Schenk, 'International financial centres 1958-71; competitiveness and complementarity', in S Battilossi and Y Cassis eds., *European Banks and the American Challenge* (Oxford, 2002), pp. 74-102.
[10] G Burn, *The Re-emergence of global finance* (London, 2006), ch 5.

[11] C.R. Schenk, 'The New City And The State, 1959-1971', in R. Michie ed., *The British Government and the City of London in the Twentieth Century* (Cambridge, 2004), pp. 322-339.
[12] Rajan and Zingales, *Saving Capitalism*, p. 262.
[13] Report by JML for Hamilton, 19 Oct. 1961. Bank of England Archive, London [hereafter BE] EID10/19.
[14] Rajan and Zingales, *Saving Capitalism*, p. 261. E Helleiner, *States and the re-emergence of global finance; from Bretton Woods to the 1990s* (Ithaca NY, 1994), p. 84. G. Burn, *Re-emergence.*
[15] For an account of the protests from the City over these controls see Schenk, 'New City'.
[16] Schenk, 'The Origins'. Burn, *Re-emergence*, p. 127.
[17] At the beginning of 1963 the US Treasury reassured banks that they did not object to their participation in the market. Memo of conversation with WB Eagleson VP of the Girard Trust Corn Exchange Bank of Philadelphia with Daane, Trued, Schott, 30 Jan.1963. US National Archives and Records Administration, Maryland [hereafter NARA] Papers of under secretary of state for monetary affairs [hereafter USSMA], Box 105, RG69-A-407.
[18] Burn, *Re-emergence*, p. 151-62.

[19] Memo of meeting of Roosa with Rickett (HMT) and Parsons (BE), 9 April 1963. NARA, USSMA, Box 106, RG69-A-407.
[20] Note by S Goldman of a conversation with Roosa, 1 May 1963. BE EID10/20.
[21] Andrew L Gomory Executive Vice President of Manufacturers Hanover Trust NY to Roosa, USSMA, 1 Nov. 1963. NARA, USSMA, Box 105, RG69-A-407. Hermann Abs of Deutschebank to Gomory, 5 Sept. 1963. The Director of the Bayerische Vereinsbank told Gomory the same, 1 Sept. 1963. NARA, USSMA, Box 105, RG69-A-407.
[22] Note by Preston to Bridge, circulated to Selwyn, O'Brien and Parsons, 4 December 1963. BE EID10/22. Losses totalled US$100m. *Economist*, 25 Jan. 1964.
[23] Bridge to Parsons and O'Brien, 5 Dec. 1963. BE EID10/22.
[24] Cromer to Holtrop (BIS), 31 Mar. 1964. Bank for International Settlements Historical Archive, Basle [hereafter BIS] FER8 7.18(10).
[25] Note by Henry N. Goldstein for Mr Young, 17 Feb. 1964. NARA, RG82 Box 76.
[26]An example was the inability of Italian banks to borrow in the market in November 1962. Note by Henry N. Goldstein for Mr Young, 17 Feb. 1964. NARA, RG82 Box 76.
[27] Note for the files by Alfred Hayes re: Conversation with W Braddock Hickman, President of the Federal Reserve Bank of Cleveland, 13 April 1964. NARA RG82 Box 76.
[28] Burn, *Re-emergence*, p. 140-4.

[29] A.B. Hersey to Robert Solomon, 19 Oct. 1967. NARA RG82 Box 76.
[30] J. Kelly, *Bankers and Borders; the case of American banks in Britain* (Cambridge Mass, 1977). p. 101.
[31] John E Reynolds to Katz, 8 Jan. 1968. NARA RG82 Box 76.
[32] *Federal Reserve Bulletin*, April 1968. p. 353.
[33] *Federal Reserve Bulletin*, October 1969. P. 774-5.
[34] Burn, *Re-emergence*, pp. 163-7. Burn does not draw on the evidence of discussions at the BIS detailed below.

[35] Frederick L Springborn, report for IMF questionnaire, 4 Nov. 1970. NARA RG56 Entry 360D NAC Actions.
[36] Obstfeld and Taylor, *Global Capital Markets*, p. 160.
[37] In 2001, cross-border share trading in Europe cost about ten times that of the USA. *Economist*, Jan. 18, 2001. For the European Commission's study group's response see Giovannini Group, *Second Report on EU cross-border clearing and settlement arrangements*, April 2003.
[38] The involvement of the BIS in the discussions over the Eurocurrency markets is described G. Toniolo, *Central Bank Cooperation at the BIS 1930-1973* (Cambridge, 2005), pp. 465-471.
[39] Short paper by BIS as basis for discussion of E$ market at meeting of experts on 6-8 October 1962, 31 Aug. 1962. BIS, 1/3A(3) Meeting of Experts, Volumes 1-2.
[40]The Americans were particularly keen to see the BIS collect data on the market to help them trace its movements and potential impact on the USA. Fred H. Klopstock, Manager Research Dept of FRBNY to M Gilbert, 28 May 1962. BIS, 1/3A(3) Meeting of Experts Volumes 1-2.
[41] The following account comes from Letter Ferras to Governor of Bank of Japan

Yamagiwa, who was not present at the meeting, 23 Jan. 1964. BIS, FER8 7.18(10).

[42] G Lefort, of the Banque de France later corrected the French position by emphasising the need to encourage banks to be more prudent in their lending. G Lefort comments on Report of Experts draft, 19 Dec. 1963. BIS, 1/3A(3) Meeting of Experts, Volumes 1-2.

[43] Jasper Rootham (BE) to Martin Gilbert (BIS), 9 March 1964. The suggestion was repeated by Governor Cromer in a letter to Holtrop, 31 March 1964. BIS, FER8 7.18(10).

[44] Letter from Ferras to central banks, 24 May 1965. BIS, FER8 7.18(10).

[45] Antonio D'Aroma Secretary General BIS, note of experts' meeting on Friday 9 April 1965, drafted 15 April 1965. BIS, FER8 7.18(10).

[46] On the failure of this proposal see also Toniolo, *Central Bank Cooperation*, p. 469.

[47] Informal record of a meeting on the Eurocurrency market held at Netherlands Bank on 18 Feb. 1971. Chaired by Ziljstra. BIS, GILB1.

[48] This was reinforced by a growing academic consensus that the private eurodollar market was probably not itself inflationary but that central banks' participation in the market was inflationary. For a survey of the contemporary debate see Hawley, 'Protecting'.

[49] Second meeting of the Standing Committee on the Eurocurrency market. 1 June 1971. BIS, GILB1.

[50] A. Teck and WB Johns, 'Portfolio Decisions of Central Banks', in AM George and IH Giddy eds., *International Finance Handbook*, 2, 1983, 10.

[51] Toniolo relates briefly how the disagreements about both the disease and the cure continued. Toniolo, *Central Bank Cooperation*. P. 466-67.

[52] Eurocurrency Standing Committee, Informal Meeting 8 Jan. 1972. BIS, GIL1.

[53] Informal record of Eurocurrency standing committee meeting 6 April 1972. BIS, GIL1.

[54] Larre in the Chair noted that not all EEC countries were in favour of monetary union. Informal record of Eurocurrency standing committee meeting, 8 July 1972. BIS, GIL1. The same views are recorded in Informal Record of Eurocurrency Standing Committee Meeting 6 Jan. 1973. BIS, GIL1.

[55] AD Crockett note for files on Committee of 20 meeting 26 March 1973, Archive of the International Monetary Fund, Washington [hereafter IMF], G142.32 C-20 Ministerial Meetings**.** Informal record of Eurocurrency Standing Committee Meeting, 9 Dec. 1972. BIS, GIL1.

[56] Informal record of Standing Committee on Eurocurrency Markets Meeting, 9 Sept. 1972. BIS GIL1. The Fed would have preferred banks to keep their deposits direct with the USA but other countries challenged them to provide better returns on US securities to attract such deposits.

[57] Informal Record of Standing Committee on Eurocurrency Markets Meeting, 6 Jan. 1973 and 10 Feb. 1973. BIS, GIL1.

[58] Report on The Eurocurrency Market presented to Committee of 20, 3 March 1973. BIS GIL1.

[59] Johnson and Abrams, *Aspects*, 18. I.H. Giddy, 'The Eurocurrency Market' in A. H. George and I. H. Giddy eds., *International Finance Handbook, Volume 1* (New York, 1983) p. 18. This section develops material from CR Schenk, 'Crisis and Opportunity; the policy environment of international banking in the city of London', in Y Cassis and E Bussiere eds,. *London and Paris as International Financial Centres in the 20th Century* (Oxford, 2005), pp. 207-228.

[60] Foreign exchange trading losses amounting to over US$100m, as against deposits of US$760m. Reid, *Secondary Banking Crisis*, 115. Wilson, *The Chase*, 213.
[61] Much larger than the Herstatt, the Franklin was left with 300 contracts outstanding, amounting to forward transactions of US$725m. *Federal Reserve Bulletin*, March 1975. Franklin National's assets were later sold to European-American Banking Corporation in Aug. 1974. S. J. Weiss, 'Competitive Standards Applied to Foreign and Domestic Acquisitions of US Banks', Comptroller of the Currency, *Foreign Acquisition of US Banks* (Washington, 1981), 303-27, 324.
[62]Negotiations with the Israeli banking authorities eventually produced a fund to which the Bank of England contributed £3m to pay creditors. Johnson and Abrams, *Aspects*, 1983, p. 21-2. Reid, *Secondary Banking Crisis*, 115.
[63] Quoted in Johnson and Abrams, *Aspects*, 23.
[64] By the end of February 1975 all consortium banks had given such an undertaking.
[65] Speech by Blunden to the Institute of European Finance of the University College of North Wales, 17 Mar. 1975 in London, *Bank of England Quarterly Bulletin*, 15:2 (1975), 188-94, 190.
[66] Quoted in Johnson and Abrams, *Aspects*, 16.
[67] Speech by Blunden to International Banking Summer School in Stockholm June 1977, *Bank of England Quarterly Bulletin*, 17:2 (1977). James, *International Monetary Co-operation*, 321.
[68] *Bank of England Quarterly Bulletin*, 17:3 (1977).
[69] At the same time the European Commission was drawing up common European banking standards.
[70] Basel I also introduced perverse incentives for banks regarding assets with high risk weights. B Eichengreen, *Capital Flows and Crises*, (MIT, 2003), p. 304.
[71] GJ Schinasi, *Safeguarding Financial Stability; theory and practice*, (IMF, 2006). p. 10-11.