

REGULATORY ASPECTS OF THE WORLD DEBT PROBLEM

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Introduction

"Give me a fast ship for I intend to go in harm's way."¹ Some may think I borrowed that line from John Paul Jones to describe the attitudes of European, Japanese, and American bankers when they set sail for the less-developed world during the 1970s. The spectacular flowering of debt problems that we have witnessed suggest that the bankers who made loans that are being questioned now were too casual in their approach to risk. The debt problems also might suggest that the regulators and supervisors who were supposed to be watching the bankers while they made the loans were either negligent or underpowered.

Actually, I chose that line because it sums up for me an approach to risk that Aaron Wildavsky (1983, p. xv) calls "resilience." In an essay on regulation, he said resilience "is the capacity to use change so as to better cope with the unknown; it is learning to bounce back."

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¹John Paul Jones, as quoted in Roscoe (1953, p. 1). Morison (1959, p. 182) has an expanded version of the line in his biography of Jones. After rejecting several captured British ships offered him by the French, Jones wrote in a letter quoted by Morison, "' I wish to have no connection with any Ship that does not sail *fast*, for I intend *to go in harm's way*. . . . I would rather be shott ashore than sent to Sea in such things as the Armed Prizes I have described.'" [Italics in original.] Morison added, "Yet it was his fate never to command a ship fast enough to force battle on a foe that chose to flee."

It does not mean rushing heedlessly into harm's way. It means being able to respond quickly to the unexpected.²

Opposed to resilience, as a way to handle risk, is "anticipation." Anticipation is the attempt to avert potential dangers before any damage is suffered. This is the approach to risk that presumably underlies the financial regulations that are the topic of this paper. The case for regulating both domestic and international financial markets rests on an assumption that managers of banks and other financial institutions, if left to their own devices, might neglect to provide adequate protection against potential risks for their depositors, stockholders, and the general public. Bankers and their stockholders cannot be left to stew in their own juice if trouble strikes, the regulators say, because sound banks are essential to the effective conduct of national monetary policies and to the general health and prosperity of the economy. Governments, therefore, impose regulations designed to limit financial managers' freedom to get their institutions into trouble.³

Today, legislators, government officials, and many members of the international financial community are seriously considering proposals for adding new regulations and reinforcing old ones in international financial markets.⁴ Bankers and financial regulators were surprised by the rise of international debt problems. There is no doubt about that. Consequently, advocates of increasing regulation and other forms of governmental intervention believe governments should provide more guidance to financial institutions in getting out of their current difficulties. They also believe that regulatory safeguards should be erected to prevent such problems from recurring.

²John Paul Jones epitomizes the quality of resilience, the ability to bounce back. Although hoping for a fast ship, he settled for a slow one, the *Bonhomme Richard*, with which he won his famous victory over *H.M.S. Serapis*, on September 23, 1779. Unable to outsail the faster, better-armed *Serapis*, with much of his crew killed by explosions of the *Richard's* own guns on the first broadside they fired, and raked repeatedly not only by broadsides from *Serapis* but also by misdirected fire from the American frigate *Alliance*, Jones took *Serapis* by boarding from the mortally wounded *Richard*. This was also the night of that other memorable John Paul Jones line, "I have not yet begun to fight." Bankers with a loan workout problem might well keep that line posted in a prominent place. See Morison (1959, pp. 221-42.).

³In arguing the view that sound banks and bank regulation are necessary for the conduct of monetary policy, a policy statement of the Board of Governors of the Federal Reserve System (1983) says, "... the Federal Reserve as the nation's central bank must remain substantively involved in the regulation and supervision of the financial and banking system because those functions impinge upon its general responsibilities." The statement goes on to assert that the System's responsibilities for regulating banks "go back to the founding of the Federal Reserve System as an institution for forestalling and dealing with financial crises."

⁴Some of these proposals are discussed in Cline (1983, pp. 98-102).

The upwelling of support for regulating international financial transactions comes at the very time domestic financial markets in the United States and other countries are being deregulated. Domestic financial markets are emerging from almost 50 years of laboring under regulations that were initially intended to prevent financial managers from repeating mistakes they were accused of making before the Great Depression. U.S. Congresses of the 1980s have had to undo financial reforms legislated by the Congresses of the 1930s.

As we examine regulatory aspects of the international debt problem, we should consider the following questions:

1. What have we learned from domestic financial regulation in the United States?
2. How did financial regulators and supervisors react to the explosive growth of international banking and international debt after 1970? Where were the police when the riot started and what did they do about it?
3. Which is the more important source of international debt problems? Is it defective portfolio management in financial institutions? Or is it instability in the world monetary framework?

Lessons from U.S. Financial Regulation

There is an inescapable dilemma in attempting to avert risk through regulation. Regulation exacts a price; regulation reduces resilience in the system.⁵ As Wildavsky (1983) argued in his essay, preoccupation with attempting to anticipate and to avert potential dangers uses up resources that might be better used in responding to actual dangers when they materialize. It also deprives people of experience in coping with failure. *John Paul Jones never had a ship of the line.* More guns and a stouter hull would have been handy when he was surprised, but he needed speed and maneuverability more.

The costs of regulation in terms of lost resilience can clearly be seen in the experience of U.S. financial institutions and markets under the regulations adopted in reaction to the Depression. I use the term regulation in a broad sense here to refer to any governmental

⁵The U.S. Strategic Air Command has a similar dilemma in the control of ICBMs. A dominant peacetime objective is to prevent accidental or unauthorized launches (called Type I errors by strategic analysts). Preventing Type I errors requires complicated physical constraints and organizational procedures, negative controls. But if war were actually to break out, the dominant objective would be to launch retaliatory attacks. It would then be important to minimize failures to launch weapons promptly against preassigned targets (Type II errors). Preventing errors of this type requires positive controls. The two types of controls inherently conflict; enhancing one diminishes effectiveness of the other. Steinbrunner (1984, pp. 37-45).

intervention that directly influences portfolio management decisions in financial institutions, from rate regulation, through conventional supervision and examination, to nonstatutory, informal direct pressures from government officials, sometimes euphemistically called "moral suasion." I shall concentrate on those regulations and interventions that influence the selection of assets and liabilities in financial institution portfolios. Lender-of-last-resort arrangements are excluded; they are discussed in Humphrey and Keleher (1984).

Failures and other difficulties of banks, savings and loan associations, insurance companies, and broker/dealer firms before and during the Depression led legislators to impose regulations designed to prevent such problems from arising again. Thomas Huertas (1983, p. 19) provides a graphic picture of the consequences for banks:

Commercial banks . . . were made scapegoats for the worst economic disaster in the nation's history. Regulation became punitive. The efficiency of the financial system was sacrificed to the aims of safety and stability.

According to Congress, stability depended on a safe banking system, and this required that each bank be safe. That in turn implied that each bank should be consistently profitable. The solution was to limit the risk to which a bank could expose itself and to restrict the competition to which a bank could be exposed.

Enforced specialization in lines of business, geographic restrictions on entry, and regulation of rates paid on deposits were supposed to keep bankers and managers of other financial institutions from engaging in excessively risky and destructive forms of competition. Deposit insurance was introduced to protect small depositors from loss in bank failures, and to prevent runs on banks.

During the 1960s and 1970s it became increasingly evident that the Depression-inspired regulations adopted in the 1930s made it difficult for U.S. financial institutions to cope with a completely different and unforeseen set of problems. The new problems for portfolio management were raised by high, and highly variable, interest rates, inflation, and a series of recessions. Banks and other institutions innovated feverishly to find ways to survive under the rate regulations that were originally supposed to protect them from risk. Arthur Burns (1977, p. 423) commented on some of the early manifestations of banker restiveness under regulation in a 1977 report to Congress:

In brief, what bankers did [in the 1960s] was to reach out for new business far more aggressively than they had formerly. To that end, they devised new techniques—many highly ingenious—for gathering deposits and making loans. . . . Banks that previously served only local markets sought to become regional in scope; regional

banks moved to establish a national presence; and our Nation's largest banks looked more and more to opportunities abroad.

He thought the pendulum had swung too far too quickly. "Excited by the profit gains that the drive for growth yielded in the 1960s, a good many bankers paid less heed than they should have to traditional canons of banking prudence" (p. 423). He expressed some concern over the fact that bank equity capital did not grow in step with bank assets.

The Chairman said uneasiness about banking trends was not just attributable to the thinning of banks' equity capital cushion. How asset growth was achieved was also of key importance (p. 424):

The 1960s witnessed the birth and rapid spread of so-called liability management by banks—a technique that in practice involved heavy reliance on borrowed funds, often very short-dated funds, to accommodate loan requests. Thus, uneasiness was engendered not only by the rapid expansion of assets relative to equity but also because that expansion rested so heavily on volatile resources.

The movement of U.S. banks abroad that Chairman Burns observed was especially interesting in view of what happened later. U.S. banks had found that the prohibition of payment of interest on demand deposits, Regulation Q ceilings on time deposits, and reserve requirements placed them at a disadvantage in competing with banks of other countries. Even more important, when interest rates rose, U.S. banks found it difficult to raise funds for their domestic loans and investments. They learned in the mid-1960s to go overseas to tap the new Eurodollar market for funds, where rates were not regulated.

According to the *Comptroller of the Currency* (1970, p. 20), there were three national banks with foreign branches at the end of 1960. These three banks' 85 branches reported total assets of \$1.6 billion. By the end of 1970, 59 national banks were operating 497 foreign branches with total assets of \$39.9 billion. The high concentration of new offices in London and Nassau suggests that the 1960s out-migration of U.S. banks was largely to gain access to Eurodollars, although it was also possible to raise Eurodollars through correspondents.

Much of the movement of U.S. banks abroad probably would have occurred eventually in any case, but domestic regulation of U.S. financial institutions and markets undoubtedly accelerated it. It is interesting to note that if regulated financial markets are supposed to be less risky than unregulated ones, the regulations themselves induced banks in this case to shift some of their operations into the presumably riskier markets.

However, regulations of the sorts adopted in the 1930s legislation did not necessarily reduce risks faced by financial institutions. This is because the regulators did not stop at promoting safe and sound conditions in financial institutions and markets. Regulation, as actually practiced, was used also to influence portfolio management decisions in pursuit of other governmental objectives. For example, deposit-rate regulation and the enforced specialization of savings institutions in mortgage lending were used to channel funds into homebuilding at preferential rates as a matter of national policy. Under the high interest rates and inflationary conditions of the 1970s, this use of financial regulation pushed savings institutions into a highly risky condition.

Another example of a shift in the objectives of financial regulation came during the 1966 and 1969 episodes of credit restraint in the United States, when the Federal Reserve System experimented with using Regulation Q ceilings on the rates banks could pay on negotiable certificates of deposit (CDs) as the "cutting edge of policy."⁶ Proponents of the "cutting edge" view had hoped that banks would reduce their business loans if a rise of market interest rates above the Regulation Q ceiling made it difficult for them to issue CDs. The long-run costs to the banks of renegeing on their loan commitments to corporate customers would have been very high, if the banks had been unable to find a substitute for CDs as a funds source. The chief result of the strategy, therefore, was to drive banks overseas to borrow Eurodollars when their domestic CDs ran off.

Regulation, furthermore, was not always based on statutory authority. For example, during the attempts by the Johnson and Nixon administrations to curb U.S. capital outflows, the so-called Voluntary Foreign Credit Restraint Program requested U.S. banks not to increase overseas loans above levels specified in relation to an earlier base period. One result was to increase bank risk by raising uncertainty about what the authorities expected and about how they might retaliate against institutions that did not comply with the "voluntary" program. Another result was to increase the participation of U.S. banks in the Eurodollar markets. Dollars raised overseas could be lent overseas, without violating the capital controls. After the controls were relaxed in December 1973, the Federal Reserve Board (1975, p. 74) reported a large increase in foreign loans from home offices of U.S. banks.

⁶For an account of the interaction of U.S. controls and the Eurodollar market, see Mcigs (1972, pp. 220-28).

The purpose of citing these cases in which U.S. financial regulations were used for objectives other than to maintain a safe and sound financial system is to remind us that new regulatory powers conferred on national governments or international agencies may not be used solely for their declared objectives either. Governments come and go; their decisions are subject to political pressures that are difficult for financial managers to predict. Therefore, we should not assume that increasing regulation in international financial markets would reduce risk and uncertainty there. It would instead bring some arbitrary powers into the picture who from time to time could change the rules facing portfolio managers, and thus increase risks.

Additional regulation would also, if the U.S. experience is any guide, reduce resilience in the international financial system by reducing the freedom of managers to adjust to unexpected changes in market conditions. Regulators tend to be slow and deliberate in adjusting their policies to changing conditions. U.S. banks and other financial institutions were fortunate in being able to use international markets for relief when domestic regulations were not adjusted to changing economic conditions in the 1960s and 1970s.

The deregulation movement made little headway against bureaucratic inertia in the United States until Congress was confronted with the prospect of disaster in savings institutions, unless deposit-rate controls were relaxed and unless institutions were granted broader lending and funding powers. People in government agencies, like anyone else, are extremely reluctant to give up any powers they may have. Furthermore, if the original purposes for which powers were conferred decline in importance, government agencies have proved to be more likely to find new uses for their authority than to give any of it up.

The Regulators' Response to Growth of International Banking and International Debt

The U.S. Comptroller of the Currency (supervisor of national banks) formed an International Division during the 1960s, to follow the Comptroller's national bank clients overseas when they opened branches to tap the Eurodollar market. Each annual report in the 1970s commented on the increases in U.S. banking activity overseas and the corresponding growth in overseas activities of the Comptroller's examining force. By 1974, the International Division had become deeply involved in "the always sensitive and difficult quality determination of loans to countries" as industrial nations and lesser-developed countries adjusted to the 1973 OPEC shock to oil prices (Comptroller of the Currency, 1974, p. 21).

The Comptroller's overseas activities appeared mainly to be adaptations of standard supervisory examination functions to meet the spreading of national bank branches and subsidiaries to locations in other countries and the growth of foreign exchange trading.⁷ Comptroller's staff members cooperated with their counterparts in the Federal Reserve System and in the supervisory agencies of other countries.

The Federal Reserve Board (1973, p. 92) issued an interpretation of its responsibilities for supervising international operations of member banks in May 1973: "... the Board has sought to assure that the international operations of member banks would not only foster the foreign commerce of the United States but that they would also be conducted so as not to encroach on the maintenance of a sound and effective banking structure in the United States."

In its Regulations K and M, the Board required member banks to use effective systems of records, controls, and reports that would keep banks' managements informed of the activities and condition of their branches and subsidiaries. These reports were to provide sufficient information for head offices to appraise the quality of loans and other extensions of credit, to identify the general sources of funds employed, and to be sure that internal and external audits of branches and subsidiaries conformed to auditing guidelines. Some of the Board's requirements, such as recent financial statements of borrowers and current information on borrowers' financial condition, must have been awkward for overseas branch managers who were trying to lend to non-U.S. borrowers for the first time. The American idea of divulging so much information to bankers did not catch on as rapidly overseas as blue jeans and John Wayne.

By 1974, the Board was beginning to express concern regarding the ability of the world's banking system to continue recycling OPEC surpluses to oil-importing countries. In its 1976 *Annual Report*, the Board said the increase in payments for oil to OPEC, combined with the low abilities of some members of OPEC to absorb imports, was a major cause of the 1974-75 world recession and the generally weak expansions in 1976. The *Report* pointed out that U.S. banks continued to expand their foreign lending from both their domestic offices and their foreign branches. In December 1976, the *Report* said, claims on Brazil and Mexico accounted for about one-half of total lending by U.S. banks to all non-OPEC developing countries.

In his 1977 report to Congress on the condition of the banking system, Chairman Burns said the quantum jump in oil prices had

⁷For a good discussion of bank supervision and examination, see Benston (1973).

contributed to unease about the health of banking, but so had the 1974–75 recession. Major domestic business bankruptcies triggered by the recession had caused well-publicized loan losses for banks. The recession had also exposed the *financial weakness of many real estate investment trusts*, which were heavily indebted to banks. New York City's financial difficulties had brought to acute national consciousness the risk exposure of banks to the vicissitudes of municipal finances. With all of these domestic consequences of inflation and recession to contend with, U.S. banks had nevertheless been *doing a commendable job overseas in recycling the OPEC surpluses*.

OPEC members could have become bankers on a major scale, the Chairman said, extending credit directly to the countries that were buying their oil. They had, instead, "shifted the banking opportunity—and with it, of course, the burden of credit evaluation—to others, which meant mainly the large American and European banks that the OPEC group used as depositories" (Burns 1977, p. 433). The supportive role that American and other banks played prevented financial strains from cumulating dangerously. U.S. export trade and the general economy had been helped by banks' international lending.

However, this useful role of U.S. banks' international lending raised some *potential hazards*. According to Chairman Burns: "Even though losses on foreign loans have been small—indeed, relatively smaller than on domestic loans—the Federal Reserve Board of Governors is concerned about the enlarged risk exposure of our banks" (p. 434).

The Chairman offered three main suggestions. First, banks should have a *heightened sense of caution in managing their international loan portfolios*. Second, the Board should be both helpful to banks and watchful of their activities. Part of the Board's effort would be a joint project with other central banks to learn more about the indebtedness of individual countries to banks. The Board was also making an informal survey of *bank practices in defining, monitoring, and controlling risk in international lending*. Third, a cooperative project should be initiated to explore financing alternatives for handling the structural payments imbalances that induced heavy bank lending to foreign countries. He thought the cooperative effort should involve, among others, official international agencies, the Group of Ten countries, OPEC, the non-oil LDCs, and the private banks.

Chairman Burns concluded his message by saying that the Board certainly did not want caution to be overdone, in the sense of making banks unresponsive to the needs of credit-worthy borrowers, either at home or abroad. Regarding the Board's role, he said (p. 436): "Nor do we as supervisors, despite our obligations to be watchful, seek to substitute our judgments for those of on-line bankers in deciding

who should get credit. We have neither the capacity nor the desire to play such a role.”

I have dwelt on this statement because it was an early official reaction to an eruption of unforeseen problems. It probably would still be a fair statement of the Federal Reserve’s approach to the international debt problems of banks, with minor alterations to recognize the special difficulties of dealing with sovereign governments. In short, the banks must stay in the international lending business, for the sake of the general health of the U.S. and world economies, while being as careful as they can be. The Board will be helpful and watchful in its supervisory role, but the possibilities for making a major difference through supervision are limited. Significant change must be sought in another arena, international cooperation to reduce the burdens on banks by finding other ways to finance or to reduce the payments imbalances of borrowing countries.

Governor Henry Wallich (1977, p. 85) added the interesting observation a few months later that while it is important to point out problem areas in the examination process, “. . . bank regulators need to be sensitive to the fact that admonishments to banks can result in damage to the credit of borrowing countries.” The Board may well have anticipated some embarrassment if a U.S. bank were to explain its rejection of a credit request from a friendly government by saying that the Federal Reserve Board did not consider the country credit-worthy. Governor Wallich thought this problem in diplomacy might be overcome by having supervisors focus on the degree of country concentration of foreign loans in bank portfolios and on the quality of information possessed by banks for assessing risks attached to their international loans.

Other high U.S. officials heard from in 1977 sent the banks essentially the same rather ambiguous message: Stay in there; your country needs you. But be careful; we will be watching you. Help is on the way; governments will eventually deal with the world debt problem. Secretary of the Treasury Michael Blumenthal and Under Secretary of the Treasury for Monetary Affairs Anthony Solomon expressed some of these ideas when trying to answer the questions of anxious Congressmen and Senators. Senator Heinz (1977, p. 2), for example, opened hearings of the Senate Banking Committee by saying, “. . . these hearings should pave the way to answer the central question of how American banks can continue to make substantial loans to LDCs without exposing U.S. creditors and taxpayers to an unacceptable level of exposure and risk and how our international financial institutions may do likewise.”

In comments that are particularly relevant to the subject of bank supervision, Secretary Blumenthal (1977) stressed the importance of information for risk evaluation. He predicted that borrowing countries would face increasing demands for information about their economies. Their ability and willingness to provide such data would increasingly constitute the price of admission to private capital markets, "because of the lenders' insistence in their own prudent self-interest, quite apart from any suggestions of the regulatory agencies" (p. 8). Lenders, he said, would need to *develop the ability to extract the maximum benefit from this additional information; they would have to refine their capability for country analyses.*

Under Secretary Solomon (1977) conceded that the growth of international debt to private lenders through the end of 1976 had been extremely large by historical standards. However, he did not think it *had reached a danger point* for the monetary system either in the sense of countries borrowing beyond their capacity to service debt or in the sense that our banks were overextended. Among the mitigating factors he cited was his observation that inflation had substantially reduced the burden of previously incurred debt measured in real terms. (What he thought inflation had done to the well-being of lenders was not recorded.) He also said, "Historical data on loan losses incurred through international lending by U.S. banks do not support the view that such loans jeopardize bank stability." He reported that the Acting Comptroller (who also is in the Treasury Department) had told a House Committee "that the extensive examinations his agency performs on national banks engaged in international lending did not reflect cause for serious concern. He [the Acting Comptroller] also said that the loan problems of major banks were *concentrated* in the real estate field and in various domestic industries." Chairman Burns had made the same point. With regard to bank supervision, Under Secretary Solomon said, "Bank supervisory agencies should *continue to exercise surveillance over external lending, as they do with domestic lending, to preserve the soundness of banking systems.*"

Thus far, we have considered the reactions of U.S. officials to the sudden growth of international banking and international debt. These developments were viewed in other countries with confusion and some alarm as well. According to Dale (1982), techniques of supervision lagged behind the internationalization of banking through the early 1970s. Supervisors were domestically oriented within their national banking systems. Apparently, not all of them displayed the alacrity of the U.S. Comptroller of the Currency and the Federal Reserve System in deploying their supervisory forces to new fields

when U.S. banks swarmed abroad. Furthermore, supervisory standards and techniques varied greatly from country to country.

The financial disturbances of 1974 raised the question of who was in charge of supervising the activities of banks operating away from their home countries. There was some fear that lack of cooperation between authorities of parent and host countries might permit some banks to escape supervision. In September 1974, therefore, central bank governors created a committee of bank supervisors to act under the auspices of the Bank for International Settlements. Members of the Committee on Bank Regulation and Supervisory Practices were to coordinate surveillance over international banking and to share ideas about how to adapt their national supervisory systems to changes in the banking environment.

Guidelines for dividing responsibilities among national authorities were approved by the Central Bank Governors of the Group of Ten in the Basle Concordat in December 1975. The Concordat included these main principles among others:

1. Parent and host authorities should be jointly responsible for supervising foreign bank establishments.
2. No foreign bank establishment should escape supervision.
3. Cooperation should include the exchange of information between host and parent authorities and the authorization of bank inspections by or on behalf of parent authorities on the territory of the host authority.

According to Peter Cooke (1981) of the Bank of England, who is Chairman of the Basle Committee on Bank Regulation, the principles for international supervisory cooperation had to be built up from virtually nothing. The events of 1973 and 1974, when a number of banks, including the Herstatt Bank, failed and others experienced serious losses, impelled central bank governors to allay concerns about the viability of the international financial system. The group's first priority was to divide up supervisory responsibilities. It decided early in its work that it would not be practical for an international body to monitor potential problems within national banking systems. That should be left to national authorities. But it agreed that supervision of international banks should be done on a consolidated basis. That is, the capital adequacy and risk exposure of international banks should be monitored on the basis of their worldwide business. This was intended to prevent banks from increasing their risk taking beyond acceptable bounds through establishing operations in countries where supervision was less stringent than in the parent country.

Like the U.S. authorities, the Basle Committee placed great stress on collecting and analyzing data on country risk. As Peter Cooke (1981) reported:

The basic attitude of supervisors generally can be simply expressed: country risk, as one form of credit risk, is a matter for the commercial judgment and decision of each bank on a case-by-case basis. But as with all kinds of risk exposure in banks' business, the essential characteristic is that it should not be excessive in relation to a bank's capacity to meet losses. The supervisors' particular concerns should be: to assist banks to assess the risks they are running by ensuring that the best possible data bearing on the lending decisions are available; to ensure that the banks have adequate internal assessment and control procedures; and to improve prudential reporting and monitoring systems.

The International Monetary Fund did not have direct supervisory authority over private institutions in financial markets, but it obviously was keeping a close eye on them as the problems of the 1970s began to build up. While preoccupied with expanding its own lending authority in the early 1970s, the IMF took time in its annual reports to look askance at the ability of private financial markets to handle the recycling of petrodollars. For example, the 1974 *Annual Report* (pp. 26-27) said:

Although financial markets appear to have operated reasonably well in the early stages of these flows, an immediate question is whether or not the Eurocurrency market will prove adequate over an extended period for the financing task that is envisaged. . . . Euro-banks may become increasingly reluctant to accept short-term deposits or to make new or additional investments in some countries badly in need of finance. . . .

. . . If such concerns are valid, they suggest that the major industrial countries should consider possible ways and means of minimizing the hazards mentioned above and assuring the maintenance of orderly conditions in the Eurocurrency market. Although industrial countries have in the past been reluctant to coordinate their financial policies in any formal way, the exigencies of the current situation call for careful watch over the operation of international financial markets.

Other international efforts to coordinate bank supervision were organized during the 1970s in almost incestuous fashion. The Organization for Economic Cooperation and Development established a Committee on Financial Markets to bring together central bankers, finance ministry officials, bank supervisors, and banks for discussion of common concerns. This Committee, in turn, spawned an Expert Group on Banking to study, among other subjects, the scope of prudential supervision in major industrial countries.

The European Community considers harmonization of banking supervision to be an element in the creation of a common market. The EEC's First Banking Coordination Directive, adopted in 1977, provided for authorization criteria, calculation of common prudential ratios and, naturally, the establishment of an Advisory Banking Committee to assist the EEC Commission. The EEC Commission and the Advisory Board are supported in their turn by an informal club of supervisory authorities known as the Contact Group, which was established in 1971 (Dale 1982, pp. 6-7).

As late as 1982, a Group of Thirty survey of bankers' attitudes found that North American banks believed they still suffered a competitive disadvantage because of domestic regulation. The proliferation of new agencies to coordinate bank supervisory efforts abroad suggests that the American banks someday will not be able to make that complaint—unless U.S. authorities find ways to roll back the deregulation movement.

This survey of official reactions to growth of international banking and the growth of international debt during the 1970s was based on public statements. The officials' private communications to banks, as in reports of examination, might put them in a different light. But, it is difficult to find evidence in their public performance to justify the common belief that regulation of financial markets and institutions leads to superior results.

For regulation to improve the performance of portfolio managers and firms, the regulators must have either superior foresight or information not available to the people making the portfolio decisions, or both. Yet when the international debt problem we are concerned with today was in its early stages, the authorities evidently were as surprised as anyone else. So much for superior foresight. As to superior information, governments did have some information not available to everyone, information primarily concerning their own policies. They could easily have solved that problem by making clearer announcements of their policies. Furthermore, lending officers who negotiated the loans that are now questioned had information not available to any regulator, plus powerful incentives for making sound loans. Today's problems probably would not be much different if the lenders had collected and analyzed additional information on current economic and political conditions at the time they made the loans.

The regulatory authorities in the United States, foreign countries, and international agencies did not really do very much to deter banks from increasing their risk exposure in the LDCs during the 1970s. Potential risks were deplored, and bankers were advised to be prudent. Committees were formed to coordinate supervisory activities

to be undertaken sometime in the indefinite future. The overwhelming concern in the minds of the authorities, however, was the role of the banks in financing the LDCs in the face of what seemed unprecedented difficulties. The authorities did not want anything to interfere with that role before the problems subsided or before alternative means of financing could be found.⁸

My conclusion about the 1970s is that the regulatory aspects of the international debt problem were not very important one way or another. The regulators, after all, were public servants in governments that had much more to worry about than the soundness of the financial system. However, regulation could become much more important in the future.

What is the Real Source of the Debt Problem?

As we consider various proposals for coping with the international debt problem, we should be aware of two potential hazards in their regulatory aspects. The first is the thickening of the supervisory blanket implied by organization of the many cooperative organizations to coordinate supervisory activities and to develop uniform standards that were discussed above. The other is the coercive element in some of the plans for remedying the debt problem.⁹ Banks are faced with the prospect of having to accept the terms of negotiations conducted for them by others whether they like them or not. Both of these potential hazards boil down to reductions in the resilience of the financial system—its ability to bounce back—at a time when we are going to need all the resilience we can muster.

With regard to the first potential hazard, supervision is meant to be helpful to banks and other financial institutions. It should be helpful if one believes supervisors have superior foresight and superior information. As I suggested above, that is a highly debatable proposition.¹⁰ Furthermore, even when supervision is innocuous, in the sense of interfering little with management discretion in financial

⁸It did not occur to me until I attended the Cato conference on January 20–21, 1984, that I might also have looked into the question of whether the regulators should have tried to protect LDCs against being seduced by banks into borrowing too much. I did not find any discussions of that question during the years LDC debt was building up.

⁹For discussion of some of these plans and their coercive elements, see Cline (1983, pp. 114–19).

¹⁰According to Benston (1973, p. 57), examiners and supervisors used to be viewed as consultants to banks, as well as auditors. “However,” he says, “the period of inexperienced bankers running small unit banks is largely a thing of the past.” Agreeing with my position, he also says that there does not “seem to be much evidence that examiners are better lending officers than those employed by banks, especially by larger ones.”

institutions, it still absorbs management time and resources that could otherwise be used for innovating and producing financial services. The reporting requirements of supervisory agencies become more burdensome each year.¹¹ In responding to the international debt problem with new regulations, governments could make mistakes comparable to those U.S. legislators made in responding to the Great Depression.

Some recent changes in U.S. bank supervision have become more intrusive than earlier ones that were confined to seeing to it that bankers follow proper procedures in making decisions. For example, the International Lending Supervision Act of 1983 breaks new ground in seeking to strengthen international lending procedures. One of the new provisions will require U.S. banks to establish "Allocated Transfer Risk Reserves" against certain assets. In the words of a December 1983 interagency statement from the three federal supervisory agencies, these are "certain assets whose value *has been found by the agencies* to have been impaired by protracted transfer risk problems" [italics added] (Comptroller of the Currency, Federal Deposit Insurance Company, Federal Reserve Board 1983, p. 3). The questionable aspect of this requirement is that, in effect, it ties up bank capital against a specific risk that may or may not materialize. I do not want to debate the merits or demerits of this particular requirement, which was still subject to review when this was written, but merely cite it as evidence of the direction in which supervision is evolving.

The coercive elements in some of the proposals for coping with the debt problem would have more serious consequences. Suppose for example, a new agency were to be established to convert outstanding bank debts of problem borrowers into new instruments with significantly different terms than those on the original debts, and the banks were to have no say in negotiating the new terms.¹² That would be an instance of the broad definition of regulation used at the begin-

¹¹Costs of bank examination and supervision in the United States are of three main kinds. According to Benston (1973), one is the direct cost of paying and supporting field examiners and supervisory and support staff. The second is the cost to banks in providing time, space, and information to examiners and the disruption of normal activities caused by field examinations. "Third," Benston says, "is the cost of foregone opportunities to the public and the banks to the extent that supervisory agencies restrict competition among banks or inhibit the banks' efficient allocation of their resources" (p. 53).

¹²The Kenen Plan, for example, would establish a corporation to issue long-term bonds to banks in exchange for debts of developing countries at a discount of say 90 cents on the dollar. It bristles with prohibitions directed at banks. For example, "banks should not be allowed to choose the debts they discount . . ." and "banks should not be allowed to decide when they will turn to the I.D.D.C." (Kenen 1983).

ning of this paper, as a direct intervention influencing portfolio management decisions. It would impose a direct cost on each bank involved. But more important would be the damage done to the institutions of property rights and enforcement of contracts that underlie financial markets.

Financial markets are built on complex bundles of property rights and contracts. The greatest service governments can perform for the financial system is to uphold those property rights, by enforcing contracts, and acting as an arbiter in case of disputes. Setting aside any of these rights, even in the interest of dealing with what is viewed as a great international emergency, should not be undertaken lightly. It would increase risks and thus would reduce the international and domestic private capital flows that are essential to future growth and prosperity of the world economy.¹³

The idea that additional regulation of banks and other institutions in international financial markets would contribute to solving the debt problem seems to me to be based on some fundamental misconceptions about the role of information and the nature of economic risk. As we saw in the review of how regulators reacted to the growth of international banking and international debt, the officials quoted placed great stress on the use of information by banks in their lending decisions. There seemed to be a general conclusion that if the banks had somehow collected more information, had analyzed it better, and had been persuaded to be more prudent, there would have been fewer disappointments later. Consequently, the supervisors are now gearing up to see to it that banks use more information, analyze it more carefully, and behave more prudently in the future. Governments, as processors of economic data, furthermore, are promising to supply more of it to banks.

If we put ourselves in the position of the bankers lending to LDCs in the 1970s, we should distinguish between *ex ante* and *ex post*. *Ex ante*—looking ahead—lenders had incentives to collect and use all of the data they could get their hands on regarding economic and political conditions that might affect the outcomes of their decisions.

¹³If bankers can be said to be culpable about anything in the international debt situation—or perhaps gullible is a better word—it is with regard to their idea of “sovereign risk.” Their faith in the role of governments as upholders of property rights and contracts within countries led them to underestimate the risk that governments themselves might set aside or modify international debt contracts unilaterally. Paul De Grauwe and Michele Fratianni (1984, p. 157), for example, say that the usual precautions taken by lenders in domestic markets, such as keeping a close eye on borrowers and prescribing penalties for undesirable borrower behavior, “do not apply to international loans because contracts cannot be enforced across national boundaries; that is, the so-called sovereign risk.”

They were like a coach picking a chess team for a tournament. He could expect some of his selections to win their matches, some to tie, and a few to lose. But *ex post*—looking back—the actual outcome was as though halfway through the tournament the game had been changed to ice hockey. A more careful selection of chess players at the beginning would not have made much difference in the second half. The change in the world economic environment when inflation accelerated in the 1970s—twice in one decade—injects risks that could not be foreseen when bankers made their initial lending decisions.¹⁴

Some bankers had taken a lead from modern portfolio theory and relied on geographic diversification to cope with the risks that could be expected to arise in a random fashion among countries as governments rose or fell, crops flourished or failed, and mineral resources were discovered or exhausted. Walter Wriston (1978, p. 84), Chairman of Citicorp, for example, explained the diversification strategy in this way: “[O]ur theory is very simple. We run what we call our actuarial base, which means that we don’t know where trouble will come from so we never have too much exposure anywhere, but we have some chips in every game in town.”

Unfortunately, the nondiversifiable risk, or systematic risk, caused by global monetary and economic instability was so great that it swamped the benefits of geographic diversification. Global monetary and economic instability also swamped the benefits of country-risk analyses that had been aimed at doing better than simply diversifying loan portfolios.

Although governments have no monopoly on foresight or information bearing on private financial decisions, they do have a monopoly on the tools of monetary and fiscal policy. If they would turn their attention to using those tools to stabilize the world monetary and economic environment, they would contribute far more to resolving the debt problem than if they try to improve the performance of the financial system through regulation.

This still leaves the question of what the regulators should do if there are widespread, major LDC defaults before the world economy becomes more stable, or if it does not become more stable. On this question, I would recommend that the regulators take the advice of the man we honor at this conference, Robert E. Weintraub. In his

¹⁴Benston (1973, p. 32) similarly attributes bank suspensions during 1930–33 to the Great Depression, which had drastically changed the financial situation from what the banks had every right to expect to prevail. “In such a time,” he said, “one cannot really fault the bankers for not having conducted their affairs in the 1920s so as to be able to withstand the plague of the 1930s.”

study, *International Debt: Crisis and Challenge* (1983) there is a section called "The Need for Common Sense by the Bank Regulators." In it he said that it would be unrealistic to require that defaulted loans be written down to zero immediately after they go into default. Doing so would assume that the defaults would be permanent and never be corrected. He recommended, therefore, that defaulted loans should be written off over a period of years, and he saw no reason why banks should not be given the time. "Given common sense behavior by bank regulators and appropriate actions by the Federal Reserve," he said, "the collapse of our money and banking systems can be ruled out even in the event of widespread defaults by LDCs" (p. 29).

Conclusion

Additional regulation would not help resolve the world debt problem. It would merely reduce resilience in the financial system, as did the regulations imposed after the Depression. In addition, it would inhibit the ability and willingness of banks and other financial institutions to do their part in restoring the health of the world financial system.

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“REGULATORY ASPECTS OF THE WORLD DEBT PROBLEM”: A COMMENT

H. Robert Heller

Introduction

The current international debt service crisis did not originate in the international banking system. It had other causes. To increase international banking regulations to alleviate the current crisis is, therefore, inappropriate. It amounts to shooting the messenger who carries the bad news.

In addition to commenting upon the paper by Mr. Meigs,¹ I would like to address the question of whether international regulatory reform is desirable in its own right, apart from the current crisis atmosphere. In particular, I will examine whether reform of the current regulatory framework would contribute to greater efficiency, prudence, and equity.

The key question of whether more regulation in international banking would contribute to a solution of the international debt crisis has been answered straightforwardly by Jim Meigs. He argues that additional regulation would reduce the resilience of the international banking system and would, therefore, inhibit the ability of financial institutions to respond to the difficult challenges before us. I agree with his basic conclusion.

Mr. Meigs has done an excellent job of documenting the failure of policy makers and regulatory authorities to foresee the present debt crisis. He draws the conclusion that giving greater power to the regulatory authorities would do little to forestall a repetition of similar problems. I would like to go one step further and argue that the

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¹A. James Meigs, “Regulatory Aspects of the World Debt Problem,” *Cato Journal* 4 (Spring/Summer 1984): 105–24.

authorities in various countries actually contributed to the economic and financial difficulties that the world experienced in the early 1980s. Rather than ameliorating the international debt problems, the authorities, I believe, unwittingly contributed to the emergence of the problems.

Of course, bankers made mistakes as well; otherwise, they would not have their current collection difficulties. But these mistakes did not *cause* the crisis. Instead, one may argue that overlending by banks helped to *postpone* the crisis. If banks had lent less, the LDCs might have gotten into difficulty in 1979 or 1980 instead of 1982 and 1983.

The Causes of the Debt Crisis

The current situation in the international financial markets is drastically different from that of the mid-1970s, when international financial shock waves emanated from the collapse of the Bankhaus Herstatt and several other banks. These difficulties had their origin in internal problems of bank management that might have been avoided if the supervisory authorities had exercised closer surveillance over the activities of the banks involved. In contrast, most of the existing international financial problems had their origin in the governmental policy decisions made in three different arenas. First, the two rounds of increases in the official price of OPEC oil triggered much of the current international economic and financial instability. Second, the policy response in the industrialized countries added to uncertainty in domestic and international financial markets. Third, the policy makers in many of the LDC debtor countries pursued economic and financial policies that were not sustainable and that worsened their own debt service problems.

The two rounds of oil-price increases brought about the largest international financial imbalances the world has ever experienced. After the first round, the current-account surplus of the OPEC countries reached \$68 billion, and after the second round, it peaked at \$115 billion. Consequently, the OPEC countries amassed large financial surpluses that had their counterpart in huge deficits in the developing countries.

The policy responses by the key industrialized countries to the two oil-price shocks differed considerably. After the first round of oil price increases, an expansionary policy of increased governmental spending and an accommodative monetary policy caused a surge in global inflation rates. Credit was plentiful and inflation-adjusted real interest rates were very low, at times even negative.

After the second round of price increases, the fight against inflation was accorded top priority and real interest rates surged to record levels. Large governmental deficits in the key industrialized countries also contributed to making credit more expensive to obtain. The already heavily indebted developing countries were hit by a drastic increase in interest rates that accelerated their debt service obligations at a time when their export prices and volumes declined sharply due to the recession in the industrialized countries.

During the 1970s, after the first oil shock, the most dynamic developing countries had been highly successful in obtaining external funds to fuel their expansionary policies at very low real interest rates. Many of these countries failed to recognize that the same development policies were unsustainable in an environment of high *real interest rates*. Consequently, they were slow to adjust their official policies and thereby contributed to an intensification of their own debt service problems.

Throughout this period, the international banking system continued to play a vital role as a financial intermediary. No other institutions were equal to the task of recycling hundreds of billions of dollars from the surplus to the deficit countries. Mr. Meigs has documented in detail how governmental officials encouraged this process. But as an increasing number of the debtor countries got into financial difficulties, the international banking system—after initially acting as a shock absorber—began to transmit the financial impulses and distress signals emanating from the debtor countries. In the process, banks accumulated large arrearages and many loans had to be rescheduled. As a result, there have been calls for increased regulation of the international banking system.

The Desirability of Increased Regulation

The international banking system coped rather well with the payment difficulties of its key debtor countries. No major bank failures occurred. The international institutional framework also coped well, and proved to be highly resilient. The Bank for International Settlements and its member banks provided initial *liquidity* assistance; the International Monetary Fund helped in the design and financing of appropriate *policy adjustments*; and the World Bank has begun the task of helping to *restructure* the badly shaken economies by working on the supply side.

The immediate crisis has been managed well. But it is appropriate to examine the need for increased regulation of the international banking system from a long-term perspective, independent of the

current crisis atmosphere. In particular, three questions must be answered to assess the need for increased regulation:

1. Would further regulation increase economic efficiency?
2. Would it enhance the safety of the international financial system?
3. Would it result in a more equitable international banking system?

Economic efficiency would probably not be increased by additional regulations. Each additional regulation places one more obstacle in the path of a free flow of economic and financial resources. Mr. Meigs argues very convincingly that additional layers of bureaucracy will not contribute to economic efficiency.

Prudential considerations are generally in the forefront of regulatory concerns. Clearly, a certain amount of supervision of financial institutions is desirable to eliminate fraud and deception. But beyond that, as Mr. Meigs points out, many of the regulatory activities are often counterproductive.

Let me illustrate by a contemporary example. The new capital-adequacy provisions for U.S. banks require a uniform ratio of 5 percent of capital against all outstanding assets. This ratio is to be applied regardless of the riskiness of the assets against which this capital is to be maintained. That is, the new regulation requires that every \$100 in assets on the books of the bank be backed by \$5 in capital. But clearly, very safe assets—such as U.S. Treasury bills and loans to the most credit-worthy borrowers, as well as interbank loans to the best banks—will not offer high enough margins to attract the additional capital required. While such assets might increase the earnings of a bank, they might not justify the additional capital costs. Consequently, bankers might be encouraged by the new regulation to deploy their funds in higher yielding, but also more risky, asset categories. The outcome of this regulation, which was designed to enhance bank safety, might actually be more risky asset portfolios.

In addition, the consequences of this regulation for the liquidity of the Eurodollar market have probably not been thoroughly considered. Interbank deposits constitute a major source of dollar liquidity for non-U.S. banks. As American banks find interbank placements yielding 10 or 20 basis points no longer attractive due to the new capital requirements, an important source of liquidity for offshore Eurobanks has begun to dry up. Consequently, the institutional structure of these important international financial markets might be weakened. This again is a result of new regulations presumably designed to enhance the safety of the banks and the banking system.

One could cite other examples of conflicting and counterproductive governmental rules. While supervisors are often calling for

increased reserves, the Internal Revenue Service will not permit banks to set aside more than 1 percent of their assets as general loan-loss reserves. While some prudential regulation is necessary and desirable, the secondary impact of the regulations should be carefully considered before new proposals are implemented.

Finally, there is the question of equity in international banking regulation. The Cooke Committee of the Bank for International Settlements has done much useful work in trying to develop internationally acceptable and equitable rules to guide supervision and regulation. These rules have eliminated some of the cracks in the system. But the Ambrosiano incident shows that it is difficult to take account of all eventualities beforehand. A flexible and pragmatic approach is clearly needed, rather than volumes of new regulations.

In considering the need for new regulations, it is useful to keep in mind the distinction between risk and uncertainty that was first introduced by Frank Knight and was recently applied to international banking by Professors Guttentag and Herring. Risk management of assets with known probability distributions of default is what bankers are trained to do. Coping with uncertainty introduced by unforeseen and perhaps unforeseeable changes in economic policy or with catastrophic natural disasters is a much more difficult task. It is appropriately delegated to the institutions designed to cope with such problems. These institutions include national lenders of last resort, such as the Federal Reserve, and the IMF as an international source of emergency funding.

Conclusion

In conclusion, I would argue that new rules and regulations will do little to improve the ordinary risk-management function of the banks and that coping with unforeseeable uncertainties is best left to the ad hoc crisis management of our national and international institutions that have served us well in the current crisis.

It took us almost half a century to dismantle some of the unnecessary regulations imposed upon the domestic U.S. banking system that were enacted in response to the emergency situation encountered in the 1930s. Let us not repeat that mistake and shackle American international financial institutions with new rules and regulations in response to a temporary crisis that was not even caused by a failure of the international banking system.