

## RESTRUCTURING FINANCIAL INSTITUTIONS IN A GLOBAL ECONOMY

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During the 1980s, governments began to retreat from regulation of the financial services industry. The retreat promises to be just as dramatic and enduring as developments during the worldwide depression of the 1930s. Although pressures for re-regulation have emerged, especially in the United States, international competitive forces are accelerating the movement toward less governmental intrusion.

The Great Depression gave rise to the corporate state and an almost universal increase in the size and scope of governmental involvement in economic affairs and in other aspects of our lives. For much of the past 50 years, governments have either owned or regulated all financial institutions that provided intermediary services. Elaborate regulatory systems, based on permission and denial approaches to administrative law, were expected to rule on which products or services could be offered, where they could be offered, and what prices or interest rates could be paid or charged to customers.

At least in the United States, there was little in the way of due process in the financial regulatory system. Regulatory agencies have operated as executive authorities that were largely immune from the discipline of the checks and balances inherent in a political system built on a framework of separation of powers. The costs associated with burden of proof were borne by the regulated, not the regulators. When a financial institution wanted to offer a new product or service, expand its market area, or combine with another institution, the regulators required it to bear the costs of demonstrating that the benefits outweighed the costs. In other words, "If you have to ask, the answer is no."

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The violation of rule-of-law principles in this system is illustrated clearly by the Federal Reserve's previous prohibition of foreign-currency denominated deposits at U.S.-domiciled institutions. A large bank requested permission to offer such deposits but received a letter from the chairman of the Board of Governors of the Federal Reserve System denying the request. No law or regulation prohibited such deposits, no congressional hearings were held to assess the proposal, and there was no public discourse on the benefits that would accrue to individuals. A simple letter of denial from a regulator was sufficient to preclude the offering of such a service. This case clearly reveals the potential for abuses in the present system of administrative law.

### Dismantling a Statist Regime

The trend toward deregulating financial services in many countries is a source of optimism about the course of events in the final decade of the 20th century. Technology and innovation have played major roles in creating pressures for deregulation. As Senator Jake Garn (R-Utah) warned in the early 1980s, "We had better hurry up and deregulate the banking industry before it deregulates itself." In addition, the general disillusionment with collectivist approaches to economic organization during the 1980s improves the atmosphere in which free-market arrangements can be discussed.

Globalization of *goods markets* gained momentum during the 1980s, as world trade volume grew at twice the rate of total output. Globalization of *financial markets* was enhanced by less-expensive communications. Globalization of *asset portfolios* now includes real estate as well as common equities and debt instruments denominated in various currencies. All of this has given rise to supra-national enterprises that operate in market areas that are much larger than the geographical boundaries of nation-states. In recent years, the trading of financial instruments began to operate on a 24-hour clock, with the resulting linkage of major debt and equity markets.

Given the state of technology and the costs of communication and transportation during the 19th and early 20th centuries, political borders often included much larger territory than did market areas for most goods and services. But for a growing number of services, such as transportation, communications, and finance, the economically efficient market area is much larger than the domain of any one or even several contiguous nation-states. Consequently, the political control of such economic activity by any one country's regulatory authorities is becoming less feasible.

Prior to the 1970s, services provided by depository financial institutions in the United States were largely restricted to individual states, and sometimes even to single counties, cities, or locations. Such restrictions became increasingly difficult to maintain as technological innovations brought down the cost of providing financial services, so that larger and larger market areas could be served efficiently. Although some critics of this trend toward the deregulation of financial services complained of competitive laxity among rival regulators, each trying to favor its own constituent regulatees, it was impossible to resist the technological imperative toward a broader geographic area of financial markets.

As we enter the 1990s, the same competitive pressures that started to bring an end to prohibitions of interstate banking, interest rate controls, and various segments of the financial industry in the United States are at work on a global basis. The result will be a substantially less regulated, if not totally deregulated, financial sector, operating on a global scale as the 21st century gets under way. As U.S. Comptroller of the Currency Robert Clarke recently asserted, "In the emerging global economy, I believe there are two types of markets: world class and second class."

### Financial Institutions in a Laissez Faire World

It may be useful to contemplate what the financial services industry would look like today if there were no governmental involvement. First of all, artificial political boundaries, such as state or provincial lines or even national borders, would not serve as barriers to the efficient provision of financial services. There would be no usury or other interest rate ceilings or floors; no quantitative or qualitative controls on the types or amounts of credit that could be extended; no limitations on or segmentation of maturities of various financial instruments; no prohibitions on the currencies in which financial assets and liabilities could be denominated; no legal reserve requirements imposed on either assets or liabilities of financial institutions; and no minimum capital requirements, margin requirements, or other regulatory restraints on the degree of leverage that could be employed. Also, governments would not create moral-hazard problems by compelling their taxpayers to provide deposit insurance.

Some financial institutions would choose to be supermarkets of financial services offering a wide array of savings and transactions instruments and forms of credit extension, as well as brokerage, underwriting, and insurance services. Other institutions would choose to position themselves as specialists in one or a few products

or financial services. Boutique institutions would serve only a local market and provide only certain specialized services, and large global networks would offer an essentially generic array of services on a high-volume, low-margin basis. The choice of location of the headquarters of these global institutions would be a function of tax laws and the efficiency and reliability of the legal system in contract enforcement. Supra-national institutions would not be identified by the national location of their headquarters, as in Japanese banks or French banks, since such characterizations would have no relevance to the consumers of the financial services offered by the institution.

Universal banks would offer a very extensive menu, including:

1. Various payment services, including not only demand or sight deposits but also credit cards, debit cards, traveler's checks, "smart cards," and money orders—all available in the currency units requested by the consumer; with various pre-authorized and individually initiated electronic payments and transfers included among the payments services;
2. Various instruments acting as stores of value, such as deposits of various yields and maturities denominated in various currencies, mutual funds (including equity or debt instruments), and a variety of interest rate or exchange rate, risk-hedging instruments, such as futures contracts, options, and swaps;
3. Brokerage-type services for acquiring or managing asset portfolios; advice on and facilitation of the administration of every aspect of personal portfolio management other than current consumption transactions;
4. Financial services for businesses, such as those currently offered by commercial banks, investment banks, merchant banks, leasing companies, and securities firms;
5. Insurance and real estate advisory and brokerage services;
6. Financial trading services, including equities, debt instruments, and foreign currencies; trading in commodities, including risk-hedging instruments.<sup>1</sup>

In some countries, a financial company currently offers many of these products and services, either under a universal bank charter or as part of a holding company of financial firms. Subsidiaries of U.S.

<sup>1</sup>A good summary of actions taken to deregulate financial services at the national level is provided in *Competition in Banking* (Broker 1989). Unfortunately, the OECD publication calls for "regulation at international level" (pp. 98–99). The "Functional Classification of Financial Services Markets" (Annex 1, pp. 107–8) is very useful and is a more detailed classification than provided here.

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banks operating in foreign countries can offer services they are not permitted to offer in the United States.<sup>2</sup>

Even though governments may continue to monopolize the issuance of national fiat currencies within their political domains, individuals and businesses will want to hold financial assets, including transactions balances, in various other currencies. In the future, we will see a growing menu of demand or sight deposits, savings balances, negotiable and marketable instruments, and mutual funds denominated in currencies other than the legal tender or currency units of the country where the financial institution is domiciled. In 1989, banks in OECD countries reported liabilities to their own residents denominated in foreign currencies equivalent to more than \$800 billion. That amount, of course, does not include foreign currency-denominated liabilities of banks domiciled in the United States, since such balances were prohibited before January 1, 1990. In recent years, mutual funds of assets denominated in foreign currencies have become more common. Increasingly, individuals will want to have the flexibility of receiving or making payments, as well as holding earning assets, in currencies other than those issued by their home-country monetary authorities.

The potential for privately issued electronic currency is starting to be developed in the form of smart-card technologies. Electronic currency is created when a microdot records a claim on an issuing institution that can be electronically transferred to other parties. The balance recorded in the microdot represents a claim on the issuing bank, which is, in effect, private currency. This privately issued money competes with the paper and coin issued by central banks and treasuries of governments. Although such balances will initially be denominated in a national currency, such as dollars, francs, yen, marks, or pounds, the outstanding float is an addition to the circulating media of exchange. Currently, travelers' checks issued by Thomas Cook, American Express, a few large European banks, and bank card companies serve a similar function of privately issued media of exchange, denominated in the unit of account of a major nation.

Technology already exists for the payment received by a seller or borrower to be different from the currency paid by the buyer or lender. This is true not only in the case of large business transactions but also in the case of relatively small transactions of individuals, facilitated by credit cards, debit cards, and travelers' checks. With

<sup>2</sup>For a survey of permissible activities for banking organizations in selected countries, see Institute of International Bankers (1988).

the elimination of capital and exchange controls and an end to the prohibitions of balances denominated in foreign currencies and of the holding and usage of credit cards issued by foreign-domiciled banks, an individual living in Rome can authorize payment from a U.S. dollar account in a Frankfurt bank to be paid in pounds to a hotel in London.

Although governments still monopolize the legal tender and units of account, they do not monopolize accepted media of exchange denominated in such units. Privately issued media, such as sight or demand deposits of banks or travelers' checks, are acceptable as a means of payment even though they are denominated in foreign currency units. Increasingly, competing currencies will become a significant dimension of the global financial system. The prescription that "high confidence money drives out low confidence money" will impose market-driven discipline on the issuance of fiat currency units.

### Financial Institutions and Economic Development<sup>3</sup>

The historical contribution of the financial system to the progress of today's Western industrial economies is widely acknowledged. The role of financial institutions and the financial system in economic development has also been studied extensively with regard to less-developed economies of the world. A study released in 1989 by the World Bank regarding financial systems and development was directed at the circumstances in less-developed countries in Latin America, Asia, and Africa. The analysis applies equally well to industrial countries and the reforming countries in Eastern Europe.

To quote from the World Bank study: "A financial system provides services that are essential in a modern economy. . . . Access to a variety of financial instruments enables economic agents to pool, price, and exchange risk. Trade, the efficient use of resources, saving, and risk-taking are the cornerstones of a growing economy" (World Bank 1989, p. 1).

The study notes: "In recent years financial systems came under further stress when, as a result of the economic shocks of the 1980s, many borrowers were unable to service their loans. In more than twenty-five developing countries, governments have been forced to assist troubled intermediaries. The restructuring of insolvent intermediaries provides governments with an opportunity to rethink and reshape their financial systems. . . . Conditions that support the

<sup>3</sup>This section draws on the analysis and conclusions presented in Jordan (forthcoming).

development of a more robust and balanced financial structure will improve the ability of the domestic financial systems to contribute to growth" (World Bank 1989, p. 1).

The World Bank study goes on to stress the importance of an efficient financial system (p. 25):

Financial systems provide payment services. They mobilize savings and allocate credit. And they limit, price, pool, and trade the risks resulting from these activities. These diverse services are used in varying combinations by households, businesses, and governments and are rendered through an array of instruments (currency, checks, credit cards, bonds, and stocks) and institutions (banks, credit unions, insurance companies, pawnbrokers, and stockbrokers). A financial system's contribution to the economy depends upon the quantity and quality of its services and the efficiency with which it provides them.

Financial services make it cheaper and less risky to trade goods and services and to borrow and lend. Without them an economy would be confined to self-sufficiency or barter, which would inhibit the specialization in production upon which modern economies depend. Separating the time of consumption from production would be possible only by first storing goods. The size of production units would be limited by the producers' own capacity to save. Incomes would be lower, and complex industrial economies would not exist.

The report stresses that "*finance is the key to investment and hence to growth*. Providing saved resources to other and more productive uses for them raises the income of saver and borrower alike. Without an efficient financial system, however, lending can be both costly and risky" (p. 25, emphasis added).

Finally, the World Bank study concludes: "Competition ensures that transaction costs are held down, that risk is allocated to those most willing to bear it and that investment is undertaken by those with the most promising opportunities" (p. 25). Applying these principles to a survey of countries around the world, World Bank researchers concluded: "The biggest difference between rich and poor is the efficiency with which they have used their resources. The financial system's contribution to growth lies precisely in its ability to increase efficiency" (p. 26).

According to the World Bank study, the reason for this result is that "even though the financial system intermediates only part of the total investable resources, it plays a vital role in allocating savings" (p. 29). That is because "smoothly functioning financial systems lower the cost of transferring resources from savers to borrowers, which raises the rate paid to savers, and lowers the cost to borrowers. The ability of borrowers and lenders to compare interest rates across markets improves the allocation of resources" (p. 29).

## Deposit Insurance, Capitalization Standards, and Reserve Requirements in the United States

If it is accepted that a strong and competitive financial services industry contributes to real economic growth, then it would seem that governmental regulations and supervision of financial institutions would be designed to foster stability and strength. Although that may be the intent, however, it is not always the result, particularly in the United States. During the past decade, the moral hazard problems associated with the deposit insurance system, in conjunction with inadequate capitalization of institutions in the thrift industry, created a nightmare for the U.S. financial industry.

### *Deposit Insurance Reform*

Recent legislation affecting the thrift industry in the United States addressed the capital standards issue of savings-and-loan associations (S&Ls) but only mandated a *study* of the deposit insurance part of the problem. Correcting the flaws in the U.S. federal deposit insurance system is essential to achieving the long-term stability of the financial industry. Among the reform proposals under discussion, something similar to the British system has considerable merit. Within the \$100,000 limit—which should be per person, not per account—the first \$25,000 would be 100 percent federally insured; the remaining \$75,000 would be co-insured by the government and private insurers. Alternatively, a depositor might decline insurance on part of the \$75,000 and avoid the private insurance premium in favor of a higher interest rate.

A new idea presented by Fred L. Smith and Melanie Tammen (1989) is intriguing. The total amount of governmentally insured deposits would be capped as of a certain date, with each depository institution grandfathered as to the amount of insured deposits to which it is initially entitled. A secondary market for federally insured deposit rights might be allowed to develop. In order to issue more deposits than are governmentally insured, an institution would purchase rights from another institution, which would then be obligated to reduce its outstanding insured liabilities.

### *Capitalization Standards*

Banking industry regulators in the United States and 11 other countries have agreed to minimum capitalization standards for banks. The objective of the U.S. bank regulators in negotiating such standards is to force banking companies to raise additional investment capital in their institutions.



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The managerial response by some under-capitalized institutions, however, has been to constrain the growth of assets or to sell assets whose current market value exceeds book value in order to record an increase in book capitalization. Such actions are causing an increase in the relative concentration of bad assets in some of the weaker institutions. Currently, regulators do not permit marking-to-market and do not count as net worth the appreciation in market valuation of asset holdings, nor do they require the writing down of assets when market value is less than book value. The emphasis on book-value accounting measures of financial capital creates an incentive to sell the strong assets and retain the weak ones, thereby creating the illusion of greater capitalization than actually exists.

This regulatory emphasis on capital derives from government-supplied deposit insurance and the potential loss to taxpayers that is associated with guaranteeing depositors against loss. Fixing the problem of deposit insurance would also promote clearer thinking about capital adequacy.

International agreements among central banks and the desire to achieve a "level playing field" among international banking organizations may continue to be used by governments to justify minimum capital standards imposed on depository institutions in the future. There is no justification, however, for imposing those same requirements on holding companies in the financial services industry. The Basle Accord should be applied at most to the banking subsidiaries of the financial institution.

### *Reserve Requirements*

An associated problem in the United States (and a few other industrialized countries) is the minimum reserve requirements on transactions liabilities that regulators have imposed on all depository institutions. In effect, these requirements serve as a franchise tax on the right to provide transactions services. The amount of the tax is equal to the foregone income on minimum reserve balances that is in excess of the level desired for clearing purposes; returns on equity and assets are thus impaired by regulation.

The intent behind minimum reserve balances was to provide both an adequate cushion in the event of adverse clearing drains and a liquid balance that could be used in the event of a run on deposits at a particular institution. Because the depository institution is legally required to hold such balances at the Federal Reserve, however, even when the deposits have already been withdrawn under a lagged accounting system, reserve balances do not provide liquidity. An especially misguided development in the United States was the

lagged reserve accounting system that was in place from 1969 until the Depository Institutions Deregulatory and Monetary Control Act of 1980 mandated a system of simple, contemporaneous, more uniform, and universal reserve requirements.

As experience has amply demonstrated, legal minimum reserve balances are neither necessary nor sufficient for the conduct of a stable monetary policy. Further, they have not provided liquidity in cases of deposit drains at large or small institutions. They have impaired the earnings of depository institutions, so that excessive reserve requirements have contributed to the safety and soundness problems of the financial industry.

Legal minimum reserve balances failed to ensure bank solvency during the runs on banks during the 1930s, largely because the central bank did not perform its lender-of-last-resort function. Consequently, deposit insurance was invented to prevent runs, but that development created the problem of moral hazard. Some regulators, therefore, think that minimum capital standards will strengthen the financial system. Other regulators imagine that mandating higher loan-loss reserves will provide the cushion they desire to protect somebody from something.

The combination of mandated idle reserve balances, deposit insurance, minimum capital standards, and higher mandated loan-loss reserves has created a highly burdensome set of rules that could ensure the continued shrinkage of the relative—and, in some cases, the absolute—size of chartered depository institutions. Yet, the demand for financial services continues to increase, and unencumbered depository intermediaries often have a comparative advantage in providing such services in the absence of excessive regulation. Forcing financial flows to find channels other than through regulated depository institutions does not contribute to the safety and soundness of the financial system.

Elsewhere in the world, reserve requirements are being reduced or eliminated entirely; it is now time for U.S. financial regulators to reevaluate the role that this tax plays. The United Kingdom has a reserve requirement of only .05 percent, which is causing other European central banks to lower their reserve requirements because of competitive forces associated with the monetary unification of Europe. In 1988, the Reserve Bank of Australia eliminated reserve requirements altogether. The Bank of Canada is also in the process of eliminating reserve requirements, because they are no longer viewed as essential for the conduct of monetary policy.

The Federal Reserve could contribute toward the restoration of the financial strength of depository institutions in the United States

by announcing a program that will reduce the reserve requirements on transactions liabilities from the present 12 percent to the current statutory minimum of 8 percent. Furthermore, legislation should be sought to permit further reductions of reserve requirements to zero or, at most, to a level that does not exceed the amount necessary for clearing purposes.

The argument against lowering reserve requirements on the grounds that such a change would reduce the revenue of the U.S. Treasury and add to the budget deficit should be rejected. It is a cynical response that places short-term political objectives ahead of the creation of a more sound and efficient financial sector. If we sincerely want to restore the health of the financial services industry, then easing the burden of the idle, non-earning assets would be a constructive first step that should be taken as soon as possible.

### Financial Stability through Regional Diversification

As one global market for financial services continues to develop, greater opportunities for diversification will emerge. The critical determinant of the extent of this global financial market will be the legal framework for the enforcement of private contracts.

Foreign experience, such as that of some regions of Canada and the performance of Canada's banking system in the 1980s relative to that of the United States, illustrates the virtues of regional diversification. Various Canadian regions and industries experienced the same boom-and-bust cycles that certain regions and industries of the United States experienced over the past decade. Canada not only experienced the same extreme economic fluctuations as the United States, but it also has a federal deposit insurance system that is very similar to the United States'. Yet, there was no financial industry crisis in Canada like the one that occurred in the United States.

During the late 1970s and early 1980s, the energy-producing province of Alberta experienced an oil boom similar to that of the southwestern United States. Subsequently, Alberta suffered a regional depression that was much like the one that occurred in energy-producing regions in the United States. Two small banks in Alberta, exploiting the moral-hazard aspect of deposit insurance (also present in Canada), took on what were determined to be imprudent risks; the banks ultimately failed when the regional economy contracted.

The seven major Canadian banks are nationwide branch-banking institutions. Thus, while these large Canadian banks lending in Alberta also suffered losses, the losses suffered in the depressed regions were offset by continued profitable operations in other prov-

inces. This feature of Canadian banking allowed the institutions to achieve a considerable degree of regional and industrial diversification in their asset portfolios. As a result, the regionalized boom-and-bust conditions in Canada did not produce the financial industry disaster that we saw with savings-and-loan institutions and commercial banks in the southwestern United States.

In the global economy, some regions expand rapidly while others grow more slowly or contract. Some regions import capital while others are net exporters of funds (depending on whether or not local residents are net importers of goods and services). A financial institution domiciled in a capital-exporting region acquires earning assets (makes loans or purchases securities) in the capital-importing regions. Institutions based in capital-importing regions facilitate the sale of local assets to foreign portfolio managers through securitization or other merchant banking and investment banking activities. An institution operating in many economic regions will achieve lower information costs about relative risk-reward opportunities and will be able to originate, service, and either hold or package for sale a regionally diversified portfolio of earning assets. Also, lower variance of average funding costs should result from regional diversification of the deposit base.

## Financial Restructuring

In many industrial countries, the banking industry has been going through a wrenching process of restructuring. The process is likely to accelerate in the 1990s, as the financial sector becomes less regulated and more competitive. There will be less room for error or bad judgments, and efficient markets will weed out the weak players.

We have already seen the near total deregulation of the pricing of financial services in many countries. Ceilings have been removed on the interest rates that banks can pay depositors, and usury laws on loans have been virtually eliminated. Competition across national borders, in the absence of exchange and capital controls, will make it impossible to maintain any interest-rate controls in the future.

Restrictions on the products that banks can offer, such as underwriting certain securities, have been eliminated in some countries and are being eroded in others. The pressure of international competition, if not legislative enlightenment, will result in the elimination of the remaining barriers.

During the 1990s, all major industrial countries will permit the emergence of financial supermarkets. Universal banks, those financial institutions that offer a full array of financial services, have long

existed in Europe. With the economic integration associated with Europe 1992, many global institutions will offer a complete line of commercial banking, investment banking, merchant banking, brokerage, and insurance services worldwide.

The United States had universal banking prior to the 1930s, and Japan's *zaibatsu* groups were dismantled at the insistence of the United States only after World War II. Much of the financial legislation and regulation of the 1930s was a big mistake and is being repealed incrementally. The Glass-Steagall segmentation of the U.S. financial industry and Article 65 in Japan are anachronistic holdovers that will disappear in the 1990s.

The certainty of the global trend to universal banking derives from international competitive pressures. Technology played a major role in breaking down onerous branching and interest-rate regulations in the United States, and it will play a role in breaking down international barriers. Financial institutions operating from a base in countries with the most efficient rules will have a considerable advantage over those operating under rigid regulations. Canada already has returned to a banking structure close to the universal banking that is prevalent in Europe. Australia and New Zealand ended the distinction between commercial banks and investment banks five years ago.

As the markets for assets and financial services become increasingly global, supra-national financial institutions will emerge. Political boundaries no longer create economic boundaries over a protracted period of time—not for goods, and certainly not for finance.

The linking of financial markets around the world will prevent any major nation from isolating its domestic money and capital markets from external events. Witness, for example, the worldwide stock market debacle of October 1987 or, more recently, the impact on the dollar of political instability in Japan and China. As technology has propelled us into an around-the-clock global financial market, banks have positioned themselves—with offices in Los Angeles, New York, London, and Tokyo—to serve international financial needs. Because goods are traded globally and portfolios of earning assets are globally diversified, some financial institutions will seek the capability to operate globally.

### Conclusion

Financial institutions now face enormous challenges, and their ability to compete effectively during the 1990s can be enhanced by

regulatory changes. On the global scene, European financial institutions will be stronger competitors as Europe 1992 becomes a reality. At the same time, Japanese banks will be repositioning themselves to maintain their dominance in major segments of the financial services market.

The evidence of the 1980s clearly supports the removal of remaining restrictions against regional and product diversification, as well as the easing of the onerous burden of reserve requirements. The free flow of savings and capital, the appropriate pricing of risk, and a wide range of innovative financial services available to consumers and businesses are crucial to an efficient, sound, and stable financial system.

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