

ESSAYS IN INTERNATIONAL FINANCE

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SUPERVISING INTERNATIONAL BANKS:  
ORIGINS AND IMPLICATIONS OF  
THE BASLE ACCORD

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ETHAN B. KAPSTEIN



INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS  
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## ESSAYS IN INTERNATIONAL FINANCE

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## SUPERVISING INTERNATIONAL BANKS: ORIGINS AND IMPLICATIONS OF THE BASLE ACCORD

### 1 Introduction

On July 5, 1991, bank supervisors in Great Britain and sixty other countries moved together to close their branches of the Bank of Credit and Commerce International (BCCI), a Luxembourg-based institution owned largely by the Government of Abu Dhabi. Over the next several weeks, a story emerged of a bank at the center of an international web of crime, espionage, and intrigue. Money from unsuspecting depositors had financed what *Time* magazine (July 29, 1991) labeled a “rogue empire.” Many will be the lessons learned from the BCCI scandal, but few will be so prominent as the need for greater regulation of international banking institutions.

Notwithstanding the BCCI case, bank supervisors have made enormous progress over the past fifteen years in coordinating regulatory policy, and, only three years ago, they reached a landmark financial agreement. The Basle Accord, concluded on July 15, 1988 by the central bankers from the Group of Ten (G-10) countries, would, the bankers announced, result in the “international convergence of supervisory regulations governing the capital adequacy of international banks” (Basle Committee, 1988). Bankers, bank supervisors, and observers of the negotiations leading to the Accord have hailed it for two prominent reasons. First, although many central bankers had expressed concern over the erosion of capital levels in commercial banks, they had entered the multilateral negotiations with conflicting definitions of what actually constituted bank capital, and how much capital banks should be required to hold. Second, national differences in capital-adequacy requirements were being exploited by banks as a source of competitive advantage in the financial marketplace; all other things being equal, banks with relatively low capital requirements could charge less for their services and still give shareholders a satisfactory return. The Basle

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I wish to thank Benjamin J. Cohen, John Goodman, Glenn Tobin, and three anonymous reviewers for their comments on earlier drafts of this essay. I also wish to thank the many central, commercial, and investment bankers and bank supervisors who gave interviews to me, and I respect their request for anonymity.

Accord reduces the scope for this type of “regulatory arbitrage” and helps to “level the playing field” on which international banks must compete.

The purpose of this essay is to explain how and why the Basle Accord was reached and to provide a provisional assessment of its effect on commercial banks, bank supervision, and international financial regulation. Writing from the perspective of a political scientist, I argue that the story of the Accord is ultimately about rule making in the international economy. It is thus a story about politics. I will show that the agreement on capital adequacy did not represent a self-evident response to the problems facing international banking in the 1970s and 1980s. Indeed, most of the G-10 central-bank governors were less than enthusiastic about discussing the convergence of capital standards when Federal Reserve Board chairman Paul Volcker first raised the issue in 1984. Instead, the Accord grew out of domestic politics in the United States, as public officials there considered the views of competing domestic interest groups in responding to the international debt crisis.

Having established that its national interest lay in pursuing a capital-adequacy agreement, the United States had to devise a strategy for placing such an agreement on the international agenda. A bilateral agreement on capital standards, reached by the Federal Reserve System and Bank of England in 1987, served this purpose nicely, for it threatened to create a “zone of exclusion” disadvantageous to the international banks of other countries. Faced with the possibility that further expansion of their banks in the United States and Great Britain would be curtailed, commercial and central bankers in Paris, Frankfurt, and Tokyo recognized that an international agreement on capital adequacy had become a *fait accompli*. In short, the story of the Basle Accord illustrates the enduring strength of the United States in shaping and advancing policies in international economic relations.

The use of state power by the United States (and Great Britain) to reach an international agreement does not imply that the objectives of the Accord were illegitimate; in fact, all central bankers would now agree that the standards adopted at Basle provide a useful framework for assessing the ability of international banks to withstand loan losses. Further, having agreed on a capital-adequacy standard, bank supervisors are currently pursuing other areas for cooperation (such as a single measure of bank liquidity). Indeed, it appears that the exercise of American power at Basle has catalyzed an international regulatory process that is spreading beyond bank supervisors. Regulators of the securities industry, for example, have also begun to work on a number

of common problems, including the capital adequacy of the firms they supervise. Again, the BCCI scandal will only serve to accelerate this trend.

Many legitimate criticisms of the Basle Accord have been raised, however, and they are also discussed in this essay. Protestations of central bankers notwithstanding, the Accord gives commercial bankers incentives to reallocate assets within bank portfolios, to the detriment of lending activity (Bhala and Kapstein, 1990). It also raises important political questions, such as whether democratic control over the regulatory process is lost when state actors pursue international agreements, creating what political scientists have labeled a “democratic deficit.”

The Basle Accord thus presents a “mixed bag” for students of international economic relations, although on balance it must be viewed as a positive development, for it provides a useful common standard that can be applied to banks based in different countries, and it rightly stresses the need for more capital in the banking system. In the following sections, I analyze the background to the Basle Accord, the G-10 negotiations that took place over capital adequacy, and the implications of the Accord for the international financial system.

## **2 Banking Crises and International Supervision, 1974-1983**

### *Economic Instability and Product Innovation in Banking*

The roots of international regulatory cooperation are found in the early 1970s. Unlike previous postwar decades, the 1970s were characterized by a unique combination of inflation, floating and erratic exchange rates, and volatile interest rates. The major commercial banks in the industrial countries, long accustomed to a benign macroeconomic environment, suddenly found it necessary to become more active in asset and liability management. In an effort to protect both their customers and their own institutions in the face of systemic shocks, bankers responded by promoting three developments in financial markets. These were globalization, innovation of financial practices and instruments, and speculation. Accompanying and contributing to these developments was the deregulation of financial markets across the G-10 countries (Cooper and Fraser, 1984).

The globalization of finance meant that banks increasingly engaged in international activities on both the asset and liability sides of the balance sheet. By the early 1980s, American money-center and superregional banks had over 800 branches overseas—up from 100 in the 1950s—and they were deriving from 30 to 60 percent of their profits from international operations (*The Economist*, 1984). As a dense network of relations



evolved within and among banks, the distinction between domestic and international finance became blurred, with net savers in one country becoming increasingly linked to net borrowers in another.

The globalization of finance limited the scope and power of domestic banking regulations. German supervisors, for example, were constrained by law from collecting information on the international operations of their financial institutions. Globalization also meant that the liquidity or solvency problems of a foreign bank or the foreign branch of a domestic bank could have serious repercussions in domestic markets. This was borne out by the spikes in interbank lending rates following the failures of the Herstatt Bank in Germany, the Franklin National Bank of New York, and the British-Israel Bank of London, all in 1974, and the Banco Ambrosiano in 1982, as well as the difficulties subsequently faced by some smaller banks in obtaining interbank loans (Spero, 1982; Pecchioli, 1983). As shown below, the three failures in 1974 prompted the formation of a G-10 committee on banking regulations and supervisory practices, now known as the Basle Committee.

The second trend, innovation, or financial engineering, was evident in the introduction of new practices and instruments throughout the 1970s and early 1980s. Among these innovations, two of the most prominent were securitization, in which traditional bank assets such as mortgages were transformed into marketable instruments, and the growing use of contingent liabilities or off-balance-sheet items. These included performance bonds (which ensure that firms, for example, construction companies, will perform their contractual tasks with customers or the bank will pay the penalty), note-issuance facilities, foreign-exchange services, letters of credit, and various instruments devised to buffer financial risks, including interest-rate caps and swap agreements. By the late 1980s, the contingent liabilities of major banks constituted a large multiple of shareholders' equity, in many cases larger than the banks' third-world debt exposure. By 1987, for example, Citicorp had contingent liabilities of \$467 billion, J.P. Morgan had \$203 billion, and Chase Manhattan had \$175 billion. These constituted more than 50 times shareholders' equity for Citicorp and over 40 times equity for Morgan and Chase.

The third trend was speculation. Given the macroeconomic instability of the 1970s, activities such as foreign-exchange trading became increasingly risky, for currency values could swing sharply on a daily basis. This volatility offered the promise of large profits for banks that bet correctly on currency movements but the certainty of heavy losses for banks that did not.

Accompanying and contributing to these changes in capital markets was the widespread deregulation of commercial banking. During the 1970s and 1980s, many of the G-10 countries lifted controls on interest rates and widened the permissible scope of bank activities. This process opened up new opportunities for commercial banks, but it also exposed inexperienced bankers to fresh dangers.

Indeed, as is always the case, it took a crisis to get bank supervisors to respond to the myriad changes in the financial marketplace (Odell, 1982). Following the failure of the Herstatt Bank, George Blunden of the Bank of England was asked by the G-10 central-bank governors to form a new Committee on Banking Regulations and Supervisory Practices, to be based in Basle at the Bank for International Settlements (BIS). The Herstatt and other failures had taught central bankers that “national banking crises could . . . rapidly take on international dimensions from which all would suffer” (Dean and Giddy, 1981). The first meeting of the newly established Basle Committee took place in February 1975, and meetings have been held regularly since that time (Basle Committee, 1989).

It was hardly coincidental that the creation of an international supervisory committee would be first chaired by a Bank of England official. By the early 1970s, London had reestablished itself as a hub of global finance, partly owing to a program of deregulation that attracted foreign banks to the city. The presence of so many foreign banks, however, raised a host of supervisory issues for the Old Lady of Threadneedle Street, which became all the more pressing in light of the bank failures mentioned earlier. It appeared that foreign bank branches and subsidiaries were escaping adequate supervision, and it was this problem that the new committee was meant to address.

#### *The Basle Committee*

The Basle Committee is made up of representatives from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States. In most cases, countries have two representatives, one from the central bank and another from a bank supervisory agency. The committee met secretly for many years, without publishing the results of its discussions. In 1981, it issued the first in what has become an annual *Report on International Developments in Banking Supervision*, and it has also published various studies and proposals from time to time.

The chief purpose of the Committee since its inception has been “to close gaps in the supervisory net and to improve supervisory under-

standing and the quality of banking supervision worldwide.” It has pursued these objectives in three ways: by exchanging information on the operations of international banks and on national regulatory policies and practices; by developing new approaches to the supervision of international banks; and by “reviewing the desirability of setting standards” in bank capital and in other areas (Basle Committee, 1989).

Because the committee was born in the crisis atmosphere of the 1974 bank failures, it naturally focused its early attention on the prudential supervision of international banks. The chief outgrowth of this concern was a document, known as the Concordat, that first came to public light in 1975. The Concordat established two principles that have since animated the Basle Committee’s work: (1) “that no foreign banking establishment should escape supervision” and (2) “that the supervision should be adequate” (Basle Committee, 1983). The significant policy implication of these phrases was that banking supervision had become a multilateral activity.

By the terms of the Concordat, primary responsibility for international banking supervision was given to the parent country’s authorities. Host supervisors were expected to regulate “foreign bank establishments operating in their territories as individual institutions.” Thus, bank branches would be supervised by parent authorities, and subsidiaries would fall under the purview of the hosts. The Concordat recognized, however, that “these responsibilities of host and parent authorities are both complementary and overlapping” (Basle Committee, 1983).

When the first draft of the Concordat was released in 1975, however, it continued to pose problems for parent authorities. Some bank supervisors, with the Germans and Swiss as prominent examples, were legally constrained in the types of information they could collect on the foreign activities of their commercial banks. Secrecy laws, for example, posed major challenges not just for national authorities, but for international cooperation as well; certain countries did not permit their authorities to exchange information with counterparts overseas. Further, it was difficult for supervisors in almost every country to make sense of the myriad, unconsolidated financial statements provided by the parent banks and their far-flung branches and subsidiaries.

To remedy these problems, the Committee developed the concept in 1981 of “consolidated supervision as a means of giving practical effect to the principle of parental responsibility.” With consolidated balance sheets, parent authorities would get a better grasp on risk exposure and portfolio concentration. The Committee also pointed out that consolidation would better enable the regulators to judge the adequacy of bank

capital in light of the whole balance-sheet profile. An important effect of the consolidation principle was that it strengthened the supervisory role of parent authorities, at least with respect to bank branches.

The necessity of strengthening the 1975 Concordat became apparent in July 1982 when Italian authorities seized the country's largest bank, Banco Ambrosiano. Among the bank's assets were over \$1 billion in overdue foreign loans, and the bank was on the verge of a collapse that would have wiped out the savings of thousands of depositors. The Italians acted quickly to "provide full backing for payment for depositors of the parent bank in Italy" (Johnson and Abrams, 1983), but they refused to provide the same service to the depositors of the Banco Ambrosiano subsidiary in Luxembourg, through which the bank conducted its Euromarket activities. The Italian authorities argued that they had no responsibility for the subsidiary, which they claimed "was neither a bank nor wholly owned." The Luxembourg regulators disagreed, arguing that Italy's central bank should indeed protect the depositors, and the country's banking commissioner, Pierre Jaans, fired off a letter to the Bank of Italy on August 12, stating that "the way in which matters have been handled is not easy to understand" (Dale, 1984).

The handling of Banco Ambrosiano by the Bank of Italy pointed to a glaring deficiency in the 1975 Concordat, namely, the resolution of responsibility for entities like the Banco Ambrosiano (Luxembourg), which the Italians did not recognize as a bank but which the Luxembourgish did. The Concordat was thus revised in 1983 in an attempt to fill in the gaps, but it again placed primary responsibility for supervision on the parent central bank. Indeed, the Concordat was amended to read that, in cases where regulators were "not in a position to undertake . . . supervision," the parent authorities of an international bank should "discourage the . . . bank from continuing to operate the establishment in question" (Basle Committee, 1983).

In light of the BCCI scandal of 1991, questions will undoubtedly be raised about the philosophy of home-country control. After all, BCCI was based in Luxembourg, but it is clear that the parent authorities lacked the resources to supervise its operations. Host authorities, for their part, attempted to monitor the bank's foreign branches, but they were apparently unable to assess the institution as a whole. The obvious lesson that will emerge from this is the need for even greater cooperative efforts on the part of bank supervisory bodies. Indeed, some observers may even be expected to propose a supranational regulatory agency. Debates about home-country control may become especially sharp in Europe, for that is the principle on which financial

integration is proceeding as the continent adopts the Single European Act. Should a major banking failure occur in Europe, the principle of home-country control could be reexamined.

It would be easy with hindsight to minimize the early accomplishments of the Basle Committee, which culminated in the Concordats of 1975 and 1983 and in the principle of consolidation. After all, despite regular meetings and information exchanges since 1974, little in the way of regulatory harmonization had actually occurred, and the supervision of international banks had not been greatly strengthened; the weaknesses of the Concordat were all too clearly exemplified by the Banco Ambrosiano failure, the third-world debt crisis (more on this below), and the recent BCCI debacle. The Basle Committee was, it seems, little more than a gentlemen's club.

This narrow view, however, would miss the larger point that the formation of the Committee itself and the progress actually made were remarkable developments. Prior to 1974, "contacts between national supervisors were scanty" (Pecchioli, 1983). Regulators acted within purely national systems, and efforts at cooperation were impeded not only by the great structural differences that made international comparisons difficult, but also by secrecy and other laws that prevented exchanges of information. In the meantime, markets had raced ahead, with an untold number of new financial practices and instruments complicating supervision of the international payments system.

With the Concordat and consolidation, the central bankers had taken the first step toward international regulatory cooperation and established a foundation for future efforts. Animated by a common fear of contagion in the event of an international banking failure, the Basle Committee began to seek new methods for supervising rapidly evolving financial markets. It also called for research on these markets, and, in the early 1980s, the International Monetary Fund (IMF), the Organisation for Economic Co-operation and Development (OECD), as well as the Bank for International Settlements (BIS), launched a number of important studies that would provide the regulators with much-needed information and analysis. To be sure, the Basle Committee did not become the center of "crisis management" when it came to bank failures; that remained the job of individual central banks. Further, the underlying weakness of the Committee as a forum for collective action would become painfully apparent during the debt crisis; indeed, it had no role at all to play in the initial response. But the Committee's utility to its member states would be clear later, when the G-10 central-bank

governors finally sat down to develop some common regulations in the face of new systemic challenges.

*The Debt Crisis and Capital Adequacy*

On August 12, 1982, as Pierre Jaans was writing to the Bank of Italy about the Banco Ambrosiano affair, Mexico announced that it would be unable to make the interest payments coming due to foreign banks. This announcement did nothing less than to spark “a truly global crisis. . . . Should the Mexican storm spread to other major Latin borrowers, such as Brazil or Argentina, there was no telling what might happen to the structure of international finance—or to the whole world economy for that matter” (Cohen, 1986).

The debt crisis posed significant policy challenges to all the actors involved—the banks, the governments of creditor states, the relevant international institutions, and, most poignantly, the debtors themselves. The crisis threatened the payments system for two reasons: first, it threatened to bring trade, investment, and financial flows between the industrial and developing countries to a halt; second, the amounts of sovereign debt owed to the banks were so large that, if the banks were forced to write them off, they would be declared insolvent. The banks lacked sufficient capital to absorb the losses, and, as depositors became aware of that fact, they would withdraw their funds, causing the banks to collapse.

The debtor countries, for their part, could not earn enough foreign exchange to meet the interest payments on their obligations. To remain current on the loans, they would have to secure more dollars—from the banks, from industrial countries on a bilateral basis, and from the multilateral lending institutions. But, following the Mexican announcement, the dollars were not forthcoming, at least from the banks. Whereas total bank claims on Latin America had increased by \$30 billion in 1981, there was no new lending at all in the eighteen months following the Mexican announcement. International financial flows to the developing world had been cut; the inevitable result would have to be the stifling of trade and investment and the weakening of the world economy.

Into the morass stepped Federal Reserve Board chairman Paul Volcker. In addition to his long experience in government, Volcker had been an international banker with Chase Manhattan. He recognized that the United States must play the leading role in meeting the debt crisis, but he also recognized the international and domestic constraints on the policy solutions he could advance. Internationally, over half the bank

claims on third-world countries were held by non-American commercial banks (the other major creditors were, in order, Japan, Britain, France, and Germany). Domestically, William Proxmire and Jake Garn of the Senate Banking Committee had made it abundantly clear the U.S. Congress would not bail out either the banks or the debtors; the great economic issues of the day for Americans were recession and the twin trade and budget deficit. In short, although the United States might be expected to initiate a policy response, the burdens of managing the debt crisis would have to be shared multilaterally.

Following the Mexican announcement, Volcker and Secretary of the Treasury Donald Regan fashioned a two-pronged strategy for dealing with the debt problem, consisting of “short-term crisis management and longer-term stabilization” (Cohen, 1986). The broad purpose of the strategy was nothing less than to maintain the international payments system. The short-term requirement was to inject enough liquidity into the payments system to maintain its uninterrupted operation. This was to be achieved through U.S. assistance packages for Mexico, bilateral agreements between the developing and industrial countries (through, for example, the Paris Club of major creditor governments), IMF stabilization credits and a corresponding increase in IMF quotas, and the restructuring of existing bank debt, along with the extension of fresh loans by commercial banks. This short-term task has continued for a decade with no end in sight. This dimension of the debt crisis has been discussed extensively, and I will not review it here.

The longer-term challenge, in contrast, was to restore the economies of the debtor countries on the one hand while strengthening the international payments system on the other. Initiatives such as the Baker and Brady Plans, IMF lending based on conditionality, and the diplomatic encouragement of economic and political liberalization were aimed at helping the developing countries reenter the international economy eventually on “spontaneous” terms. Again, this aspect of the crisis has been adequately discussed (Cline, 1983). The American strategy for dealing with the banks is less well known.

As a result of the bank failures of the 1970s and early 1980s, the public had begun to lose confidence in the banking system. Bank portfolios were filled with dubious or high-risk loans and with such novelties as swaps, note-issuance facilities, and other instruments to borrowers of uncertain creditworthiness. Bank profits were falling and share prices with them. As share prices fell, so did the ability of banks to attract equity investment to build up core capital. A vicious cycle was thus taking hold and threatening to undermine the major commercial

banks—the institutional foundation of the international payments system.

It was thus imperative that public confidence in the banks be maintained. Otherwise, depositors would panic and a run would begin. Once started, the process could easily spread to all the major international banks, with ill-informed depositors unable to distinguish between weak and strong banks. Because the major banks had become heavily interdependent through the interbank market (the international market in which banks loan excess funds to one another), a run on an international bank in one country would inevitably lead to a global stampede, requiring massive central-bank intervention.

Fear of a global banking crisis has afflicted bank regulators since the Great Depression, and its influence on them cannot be exaggerated. During the 1930s, “more than one-fifth of the commercial banks in the United States suspended operations.” In Europe, “major bank failures or payments moratoriums were common. Withdrawals of bank loans and deposits played a major role in the balance of payments crises of the period, particularly in Central and Eastern Europe.” Overall, “the Great Depression of the 1930s could be defined in terms of financial collapse” (Johnson and Abrams, 1983, p. 1). Nevertheless, in the 1980s, as in the 1930s, no single central bank was willing to act as lender of last resort for all the commercial banks and sovereign borrowers in distress (Kindleberger, 1973).

To be sure, since the 1930s, central bankers have developed a set of regulatory safety nets the purpose of which is to maintain the soundness of individual banks and, when necessary, “to keep financial systems functioning in the face of economic shocks.” These include (1) prudential measures to maintain bank solvency, (2) prudential measures to protect bank liquidity, (3) official assurances such as deposit insurance to convince depositors that their deposits are safe, even with troubled institutions, (4) orderly resolution of the problems of failing banks, and (5) in the last resort, official provision of liquidity to permit solvent institutions to keep functioning in the face of a loss of depositor confidence (Johnson and Abrams, 1983, p. 1).

In providing these defenses, however, bank regulators have created for themselves a “moral-hazard” problem. As the authorities have provided systemic safeguards, they have also encouraged imprudent behavior on the part of some financial executives. If bank depositors were more like shareholders, they would try to prevent management from engaging in careless banking practices. Regulators have assumed, however, that depositors have generally lacked the information necessary to monitor either the prudence of their bank’s lending policies or the



overall quality of the bank's portfolio. Naturally, the information problem is compounded in a global economy, in which depositors from country A may place their savings in a bank with operations in countries B, C, and D; indeed, they may do their banking with the branch office of an international bank the headquarters of which is located in country E.

Ironically, an international agenda to strengthen the banking system emerged in 1983-84, not as a collective solution to the debt crisis on the part of central-bank governors, but as an outcome of domestic politics in the United States. With the Mexican announcement, the Reagan administration found itself in the ironic position of backing an increase of IMF quotas at the IMF's annual meeting in Toronto in September 1982 and urging other countries to respond as quickly as possible to the request.<sup>1</sup> By early 1983, the administration's request for \$8.4 billion in IMF funding was being presented to the Congress, where it met a less than warm reception (Cohen, 1986).

Indeed, in both the Senate and the House, the leading bank supervisors, Paul Volcker of the Federal Reserve Board, C.T. Conover of the Office of the Comptroller of the Currency (OCC), and William Isaac of the Federal Deposit Insurance Corporation (FDIC) were told to come back with a new regulatory program before making the IMF request. As Senator Garn stated, "There will be legislation. . . . The price of \$8.4 billion in the Congress is going to be legislation . . . so we can go home and say we didn't bail out the big banks" (U.S. Congress, Senate, 1983, p. 95).

The three supervisors returned on April 7, 1983 with a joint "Program for Improved Supervision and Regulation of International Lending." The program contained five key elements: (1) the strengthening of the existing program of examination and evaluation of country risk, (2) increased disclosure of banks' country exposure, (3) the creation of special reserves against losses (allocated transfer risk reserves [ATRRs]), (4) supervisory rules for accounting for fees associated with loan transactions, (5) strengthened international cooperation among foreign banking regulators and through the IMF (U.S. Congress, House, 1983, p. 234).

The issue of capital adequacy was also raised by the supervisors, but *not* in a multilateral context. They stated in their memorandum that "federal banking regulators will . . . analyze a bank's capital adequacy

<sup>1</sup> During its first two years, the Reagan administration had stood in opposition not only to IMF quota increases, but more generally to the IMF's way of doing business (Cohen, 1986).

in relation to the level of diversification of the bank's international portfolio. Those institutions with relatively large concentrations will be expected to maintain generally higher overall capital ratios." International cooperation was not to focus on the issue of capital adequacy per se but rather "to help achieve the objectives of risk diversification and strengthened financial conditions that we have set for ourselves" (U.S. Congress, House, 1983, p. 234).

In congressional hearings, the U.S. banks warned that any new unilateral regulations could result in decreased international and domestic lending as well as a loss in relative competitiveness in relation both to foreign banks and to nonbank financial institutions. The banks argued that relatively high capital requirements in the United States had already placed them at a competitive disadvantage to the Japanese and French, and this line of reasoning was taken seriously in Washington, whatever its merits. Indeed, Representative Charles Schumer of New York, a regular target of bank lobbying, stated plainly during the IMF hearings that "we cannot put our banks at a competitive disadvantage to German, Japanese or other banks" (U.S. Congress, House, 1983, p. 183). The bankers' pleas placed Congress in a quandary. The congressmen wanted tighter regulations, but they did not want American banks to suffer competitively as a result. A Solomonic decision was thus made by William Proxmire and John Heinz of the Senate Banking Committee.<sup>2</sup>

The senators appeared to agree with the supervisors, for two reasons, that capital levels in international banks should be raised: (1) bank capital had the quality of a "public good," in that its social benefits were greater than its private benefits; if each bank were to raise more capital, it would help to restore confidence in the international financial system as a whole; and (2) the imposition of tougher capital standards would demonstrate that the American taxpayer alone would not have to recapitalize the entire financial system through bilateral assistance to debtors and the U.S. share of increased IMF funding; the burden would also be borne by bank shareholders.

Tougher standards for U.S. banks, however, might permit highly leveraged Japanese and French banks to gain market share at the expense of domestic institutions. In that case, the system as a whole

<sup>2</sup> Both the congressional hearings and the interviews conducted for this essay suggest that international convergence of capital-adequacy standards was put on the table by Congress rather than by the regulators.

would be no stronger and American jobs would be lost. Congressmen were concerned about the safety and soundness of the international financial system, but they were also paid to worry about competitiveness and jobs. The obvious solution to this dilemma was to promote international convergence in banking regulations, particularly in the area of capital adequacy.

The IMF quota increase, regulatory concerns about capital levels, and the banks' fears of unilateral regulations were synthesized in the subsequent IMF-related legislation known as the International Lending Supervision Act (ILSA) of 1983.<sup>3</sup> In addition to legislating the recommendations put forth by the bank supervisors in early April, ILSA called upon the regulators to require increased levels of bank capital, and it encouraged "governments, central banks, and regulatory authorities of other major banking countries to work toward . . . strengthening the capital bases of banking institutions involved in international lending." If the banks were going to be forced to raise capital, at least it would be done on a multilateral rather than a unilateral basis.

The outcome of the political debate over banking regulation exemplifies American politics both domestically and internationally. On the domestic level, the Act reflected the interests of competing groups, particularly regulators and banks. Internationally, it placed American concerns and preferences on every other state's agenda. In short, ILSA was a distinctively American policy product.

This does not mean that the ends ILSA sought to attain were illegitimate. After all, the international payments system *was* threatened by the debt crisis, and higher levels of bank capital could help to restore public confidence. To the extent that the payments system had the character of a public good, however, it was reasonable to ask every state to contribute to its maintenance. In this light, ILSA and the congressional endorsement of international regulatory convergence can be viewed as part of a burden-sharing exercise arising from the debt crisis.

With the passage of ILSA, the issue of bank capital had become an ongoing agenda item for the U.S. Congress. The Federal Reserve Board and U.S. Treasury Department were called upon to issue a progress report on international negotiations within one year of the Act's passage, and Congress, at the request of House Banking Committee chairman Ferdinand Saint-Germain, also asked the General Accounting Office to present its own report on the activities of the Basle Committee.

<sup>3</sup> In the best Washington tradition, this Act was passed as Title IX of a large housing bill.

Saint-Germain further demanded that the FDIC be given a seat on the Basle Committee, in order to check the growing power of the secretive Federal Reserve in regulatory affairs.

In accordance with the ILSA requirement, Paul Volcker dutifully presented the congressional request for convergent capital standards to his fellow central-bank governors at a meeting in Basle in March 1984. In the words of one Federal Reserve Board staff member, his presentation was “greeted with a yawn.” Although the Basle Committee had issued a paper expressing concern about the erosion of capital levels in international banks and had urged in 1982 that no further deterioration be allowed, it seemed to the central bankers that policy convergence was too much to ask, given the vast differences in national banking systems. As Volcker and Regan (1984) put it in a May 1984 report to Congress, “the difficulties involved . . . were recognized as substantial.”

Nonetheless, the Basle Committee did make progress during 1984 with regard to cross-national comparisons of capital levels. Recognizing the different definitions of capital and the varying methods for calculating capital-to-asset ratios, the Committee devised a “framework” that enabled central bankers to compare their national methodologies and statistics. By providing a single framework, the sharp differences in standards and capital levels became readily apparent (Basle Committee, Annual Report, 1984).

Shortly after Volcker’s presentation to the Basle Committee, bank capital once again emerged as a domestic political issue in the United States. In May 1984, the eighth largest bank in the United States, Continental Illinois, required a \$6 billion infusion of Federal Reserve funds to meet its immediate financial obligations. The story of Continental Illinois is a textbook case of a bank that combined high leverage with a risky portfolio in its reckless pursuit of market share. Bank management had failed utterly in its job of asset and liability management, and, by early 1984, rumors about asset quality were leading institutional investors to withdraw their deposits. Despite the emergency infusion of Federal Reserve cash, the bank collapsed and a federal bailout followed. In the aftermath of ILSA and the Continental Illinois debacle, bank regulators found themselves under renewed pressure from Congress to bolster the supervisory process.

Congress was concerned that commercial bankers might believe the Federal Reserve, having saved the eighth largest bank, would save any large institution, no matter how poor its management quality and “how substandard its loan portfolio might happen to be” (Cohen, 1986). Further, observers might infer the United States was now willing to

bail the banks out of their third-world bad debts without any serious adjustment on the part of the banks. This, of course, posed the moral-hazard problem writ large.

In fact, the Federal Reserve wanted the banks to make every effort to strengthen their balance sheets through the financial markets before any more of them had to seek assistance from the federal government. Of greatest concern to the bank supervisors was the integrity of the deposit insurance fund, which would come under tremendous pressure if any other large banks failed. Maintaining this fund involved actions on both the asset and liability sides. On the asset side, the Federal Reserve would emphasize loan quality in the banks it examined; on the liability side, new capital-adequacy standards would be established and capital levels increased in banks where the regulators felt it necessary. The more capital available to absorb loan losses, the greater the protection for the insurance fund.

In search of a new capital-adequacy standard, bank supervisors at the Federal Reserve Board in Washington and the Federal Reserve Bank of New York began to explore the regulations in place overseas; the supervisors were assisted in this effort by a staff report of the Basle Committee that compared capital requirements across the G-10 countries. At this time, the Federal Reserve System and other bank regulators (the OCC and FDIC) were using a fixed capital-to-asset ratio. Banks were required to hold \$5.50 of capital (defined as shareholders' equity and the loan-loss reserve) for every \$100 of assets, no matter how good or bad the asset quality or what type of asset was being held. The fixed ratio did not, however, take into account the off-balance-sheet items that had accumulated in large banks; these had been one source of Continental Illinois' problems.

The American system appeared hopelessly simplistic in comparison to those in place in several G-10 countries, notably Belgium, France, and Great Britain. These countries had developed and put into use sophisticated "risk-weighted" capital-adequacy standards that required banks to have more capital as the riskiness of the portfolio increased. Banking supervisors determined appropriate capital-adequacy standards for each of the financial institutions they supervised in informal meetings with the bank's managers.

These risk-weighting systems, it must be noted, had been developed long before the outbreak of the debt crisis. Indeed, the Bank of England had formulated its capital-adequacy system, not in response to the debt crisis, but in response to the "secondary" or "fringe" banking crisis that had threatened Britain's domestic financial system in the mid-1970s; it

issued new regulations on bank capital in 1980. Traditionally, capital had not been a focus of British regulation, but, with the collapse of a number of poorly capitalized institutions that had overextended themselves in real estate (akin to the contemporary savings-and-loan crisis in the United States), the Bank had begun to develop new standards. Ironically, as it studied various national approaches to capital adequacy following the fringe crisis, it looked to the experience of the Federal Reserve Board, which had a considerable history of regulating bank capital. Rather than use the Federal Reserve's fixed capital-to-asset measure, however, the Bank of England opted for a risk-weighted system (Wesson, 1985), though a system that differed in several respects from those found in other European countries. Thus, as a result of domestic crises, the capital-adequacy regulations of the United States and Great Britain were beginning to converge.

United States regulators other than the Federal Reserve were initially not keen on adopting new capital-adequacy standards, for both political and technical reasons. They did not want to engage in a battle with their banking constituents, and they believed the British standards were too complicated to implement. After all, the United States had over 10,000 commercial banks, and it would be impossible to determine capital-adequacy standards on a case-by-case basis, as was widely done in Europe. After further study of the risk-weighted system, however, FDIC chairman William Seidman changed his mind. In remarks to a banking conference held in Britain, Seidman thanked the Bank of England "for providing us with the results of their analysis on off-balance-sheet risk." He also stated that "an international standard for capital would be most welcome, since it is difficult to make valid comparisons when every country counts it differently" (Dale, 1986, p. 78). With Seidman's support for a risk-weighted capital standard, the American regulators could move forward with a single voice.

### **3 The International Politics of Bank Capital Adequacy**

#### *The Federal Reserve System's Proposal*

In January 1986, the Federal Reserve Board released for public comment a "supplementary" capital-adequacy standard for commercial banks, based on the risk-weighted system. In addition to the fixed capital-to-asset ratio of \$5.50 to \$100, the Board would analyze capital adequacy in terms of the riskiness of the portfolios of international banks. Different "weights" were assigned to different categories of assets and to the off-balance-sheet items. The dollar amounts held in each

category were then multiplied by the assigned risk weight, with the total giving the “risk-weighted assets” measure. Thus, cash was assigned a zero weight, meaning it would not be counted at all in the asset measure; U.S. government securities were given a 30-percent weight; and all loans and off-balance-sheet items were assigned a 100-percent weight (Federal Reserve Board, 1986).

The Board provided three reasons in support of its new proposal: (1) the need to address the growth in off-balance-sheet exposure, (2) the need to reward conservatively managed banks holding relatively high cash balances, and (3) the need to bring the United States into line with those industrial countries that had already introduced the risk-weighted standard. The Board further asserted that stronger capital regulations were necessary in light of the growing risks associated with international banking.

As expected, the bankers protested the unilateral measure. The American Bankers Association ([ABA] 1986) told the Federal Reserve Board that the proposal would exacerbate the competitive inequities that existed between U.S. commercial banks and their foreign peers and also between commercial and investment banks, which were not subject to the new capital regulations. In sum, the ABA stated that the proposal would undermine “the ability of U.S. banks to compete.”

As in the ILSA hearings in 1984, the bankers’ concerns about competitiveness were taken seriously and seen to confirm the need for continued international negotiations to promote convergence of capital-adequacy standards. The domestic politics of bank capital had come full circle, but how should the international negotiations proceed?

Given the earlier work of the Basle Committee in this area, the Federal Reserve Board might have been expected to relaunch multilateral talks within its structure. Further, the Board was aware that the members of the European Community (EC) were holding talks on harmonization of capital standards as part of the EC’s 1992 project; it would have been natural to seek harmonization of standards between Brussels and Basle, for most G-10 members were also part of the EC.

But earlier efforts in Basle on capital adequacy had failed to make much progress, and there was a feeling at the Federal Reserve Board that the Basle Committee was not pursuing the issue as aggressively as it might, perhaps because the Committee’s chairman, Peter Cooke, of the Bank of England, doubted the feasibility of the task. Further, the central bankers of the member countries continued to defend their national standards as appropriate to their particular banking structures. The Germans, for example, had argued that their “universal banks” were

unlike the commercial banks found in the United States and thus had different capital requirements. There was no separation in Germany, for example, between banks and industrial enterprises, or between banks and securities firms. It made no sense to seek a single, international capital-adequacy standard given these national structural differences (Kapstein [1992]).

At this point, the Federal Reserve Board had three options. It could continue to negotiate in Basle; it could adopt its new standard domestically; or it could seek a piecemeal extension of the new standard to countries that had already adopted similar risk-weighted capital-adequacy measures. With regard to the last option, a joint effort with the Bank of England was tempting, for the Board had already drawn upon the Bank's capital-adequacy standard in developing its own policies. The possibility of striking a bilateral agreement with the Bank of England was made even more attractive by the fact that a single standard in "both New York and London, two of the most powerful financial markets in the world, would represent a major step toward convergence on the issue of capital standards" (Tobin, 1991).

#### *The Accord between the United States and the United Kingdom*

In July 1986, Paul Volcker suggested to Bank of England governor Robin Leigh-Pemberton a joint U.S.-U.K. agreement on bank capital adequacy. According to Volcker, "they quickly agreed. The speed with which they jumped on it surprised me" (Tobin, 1991). For the British, a joint approach with the United States would provide a powerful counter to the EC's emerging standard, to which the Bank of England had objected. Now, the British and the Americans were in a powerful position to advance their preferences.

In January 1987, the Federal Reserve System and the Bank of England officially announced that they had reached agreement on common standards for evaluating capital adequacy. This banking accord was immediately hailed as a "landmark in financial regulation" (*Financial Times*, May 7, 1987, 4:3). Specifically, the agreement provided for (1) a common definition of capital, which comprised shareholders' equity, retained earnings, minority interests in subsidiaries, and perpetual debt, (2) the adoption of a risk-weighted system for evaluating capital adequacy, and (3) the inclusion of all off-balance-sheet commitments in capital-adequacy determinations. No minimum level of required capital was proposed in the agreement (Kapstein [1992]).

Paul Volcker (1987) vigorously defended the U.S.-U.K. accord in hearings before Congress. It was designed, he said, to meet "several



partly conflicting objectives.” These included the need to address the rapid growth of off-balance-sheet commitments, the creation of a measurement system that would avoid government determination of resource-allocation decisions, the desire to promote regulatory convergence, and the effort to establish a fair competitive standard that all international banks should meet. Volcker stressed this last point. “I cannot emphasize strongly enough,” he said, “our interest in the competitiveness of U.S. banks.” This statement is of particular interest in light of the subsequent comment by the secretary of the Basle Committee, Peter Hayward (1990), that the Basle Accord was not “created to ensure fair play, but to ensure the safety and soundness of national banking systems and to protect the interests of depositors.” Perhaps he was responding to criticism that the Accord had not done enough to ensure fair competition, but, in truth, the capital-adequacy standards were designed both to strengthen the international payments system and to ensure fair play, and these objectives were seen as mutually reinforcing.

The banks, however, again expressed their dissatisfaction with the Federal Reserve Board. Ira Stepanian, president of the Bank of Boston (1987), told the Board that he had “serious concerns with the . . . Proposal as it related to competitive equity, not only between U.S. banks and those overseas, but also between U.S. banks and nonbank financial institutions.” He noted that “a major segment of worldwide banking had been left out—including Japan which now has seven of the top ten banks in the World.”

#### *The Basle Accord*

American and British supervisors recognized from the outset the problems inherent in their bilateral strategy. On the one hand, it could harm relations between Britain and the European Community—indeed, European Commission president Jacques Delors had complained to the chairman of the Basle Committee, Peter Cooke, that the U.S.-U.K. agreement was not “communitaire.”<sup>4</sup> On the other hand, the United States was concerned about the general feeling of ill will that might be created among other G-10 central-bank governors. Nonetheless, the United States and Great Britain wanted to ensure the extension of their standard, and they adopted a two-track route in 1987 (Kapstein, 1989).

<sup>4</sup> An interview provided this information concerning Delors’ complaint. Other interviews revealed that Cooke himself was disappointed that the Bank of England and the Federal Reserve System went the bilateral route, rather than continuing to work through the Basle Committee. Thus, he agreed with Delors’ pronouncement.

The Bank of England and the Federal Reserve pursued direct talks with bank supervisors in Japan and the major Western European countries, while also reopening discussions in Basle. In January, the president of the Federal Reserve Bank of New York, Gerald Corrigan, traveled to Tokyo, where he told officials that “the most important reform” Japan could undertake in the financial area would be “a better alignment of Japanese capital requirements with those of other leading industrial countries” (Rehm, 1987). Meanwhile, the head of banking supervision at the Bank of England, Brian Quinn, traveled to several European capitals in an effort to sell the capital accord.

At the same time, pressure was placed directly on the Basle Committee to respond quickly to the joint accord. A series of special meetings were held, in which criticism of the bilateral agreement was aired. Although these discussions were tough, it was already clear to the participants that some agreement would ultimately be reached (Hayward, 1990). The fact that the United States and Great Britain would hold international banks to the new standards, and the threat that they would not approve banking applications from international banks that did not adopt their capital-adequacy measure, made a Committee proposal inevitable.

Yet the U.S.-U.K. agreement was not simply forced upon the other G-10 countries. In their negotiations with both individual countries and the Basle Committee, the United States and Great Britain took account of the differing national systems that made a straightforward extension of their agreement difficult to accept. It was obviously in the interest of the Bank of England and the Federal Reserve to shape a standard that every G-10 member could agree to and, just as important, live up to by domestic enforcement.

For the Japanese, the major concern was accounting for the “hidden reserves” held by banks, including real estate and corporate equities. The Ministry of Finance and the Bank of Japan asserted that hidden reserves should be “marked to market” (that is, equities and real estate should be assigned their market rather than historic value) and the resulting capital gain added to base capital. The British and Americans objected, stating that existing regulatory and accounting rules prevented their banks from valuing similar holdings at market levels. Negotiations on this and other matters continued throughout the summer of 1987, and, by September, the United States, Britain, and Japan “had come to terms on the broad outline of an international agreement” (Tobin, 1990).

The trilateral accord permitted the Japanese to count up to 45 percent of the unrealized gain on securities and other equities as part

of base capital. It was also agreed that the risk-weighted system would be phased in over a five-year period and that international banks would be evaluated according to the new system at the end of their 1992 fiscal year. That year, of course, coincided with the deadline for implementation of the Single European Act adopted by the European Community and, more specifically, with the Second Banking Directive. Because the EC itself was having ongoing discussions regarding harmonization of banking regulations as part of the 1992 program, it was important that the new capital-adequacy standard meet the concerns of the European members of the G-10.

For the Japanese, the trilateral agreement was not difficult to accept. The Tokyo Stock Exchange was booming in late 1987, making an increase in bank capital relatively painless, especially in light of the provision regarding valuation of hidden reserves. Indeed, critics claimed that U.S. negotiators had done nothing to restore the competitive balance, which the authorities had claimed as one of their objectives. Yet the point of the exercise was not to make it easy or hard for banks to reach the new standard; it was simply to establish one standard that every bank must meet. If Japanese banks *were* well capitalized, so much the better.

The talks in Basle went at a slower pace than the trilateral discussions, but news of the agreement between the United States, Britain, and Japan led to an acceleration of the process; with Tokyo on board, it was clear to any remaining recalcitrants that a bargain must be struck. Discussions in Basle focused on the definition of capital and how much of it banks must hold; the risk-weighted system itself was no longer a point of debate.

During the autumn, the Committee made breakthroughs on both fronts. First, a two-tiered capital framework was established, which elegantly provided a common standard while respecting national differences. Tier-one capital was confined to shareholders' equity; tier-two capital included loan-loss reserves, up to 45 percent of the unrealized gain on marketable securities, and hybrid debt-capital instruments. Second, a minimum risk-adjusted capital-adequacy standard of 8 percent was agreed upon, half of which (4 percent) had to be in the form of tier-one capital. These levels were to be attained by the end of each bank's 1992 fiscal year, as had already been agreed by the trilateral group.

In addition, the Basle Committee assigned risk weights to the various asset categories, differing in some instances from those used in the U.S.-U.K. accord and its subsequent extension to Japan. Cash was assigned a zero weight, so that no capital would have to be held in support of

currency, coin, or balances held with the central bank. Short-term government securities were also assigned a zero weight, and long-term securities, municipal bonds, and securities issued by countries outside the OECD were given weights ranging from 10 to 100 percent. Loans of all types (with the exception of those collateralized by cash) were given a 100-percent weight, as were residential mortgages on rental property; this last would subsequently become a cause of controversy between regulators and domestic interest groups in the United States and elsewhere, as described below. Off-balance-sheet items were assigned an “asset equivalent” and given the appropriate weight; in most cases they would be considered the same as loans (Basle Committee, Annual Report, 1987).

On December 10, 1987, the Basle Committee announced that its members had reached agreement on a proposal for “international convergence of capital measurements and capital standards.” The achievement of a capital-adequacy accord, the Committee stated, was a “desirable objective in order to remove an important source of competitive inequity for banks operating internationally” (Annual Report, 1987)—again, it is curious that the Committee’s secretary, Peter Hayward, would back away from the competitiveness issue in his recent commentary (Hayward, 1990). With the issuance of the preliminary Basle Accord, a new, risk-weighted, international capital-adequacy standard emerged in less than one year out of the bilateral U.S.-U.K agreement.

During the six-month comment period following the December announcement, bank supervisors in the G-10 countries received a number of suggestions concerning changes that might be made in the final version of the Accord. First, American and British bankers sought to include perpetual preferred stock as tier-one capital. Second, bankers and real-estate interests were determined to see that all residential mortgages, including those on rental property, be treated as “collateralized” loans and therefore given a lower risk weighting. Third, commercial bankers expressed the view that it was inappropriate to assign the securities of all non-OECD countries a 100-percent weight, which would not only penalize those countries that were good credit risks but would also make it more difficult for banks operating in non-OECD countries to access interbank markets. Finally, banks suggested a number of changes regarding the treatment of off-balance-sheet items (Federal Reserve Board, 1988).

In response to the comments collected from commercial banks and other interested parties, the Basle Committee members met again in July 1988 to discuss revisions of the preliminary agreement. A number

of major changes were made, including the acceptance of perpetual debt as tier-one capital and a lowered risk weighting on rental properties. Claims on the banks of non-OECD countries were also awarded a lower risk weight, as were several off-balance-sheet items. The Committee released its final version of the Basle Accord on July 15, 1988, under the title *International Convergence of Capital Measurement and Capital Standards* (Basle Committee, 1988).

#### **4 Evaluating the Basle Accord**

The Basle Accord provoked substantial and immediate controversy. Critics claimed, as they had with the bilateral U.S.-U.K. agreement, that it represented nothing more than a central bankers' conspiracy to allocate resources, providing the banks with powerful incentives (in the form of lower risk weights) to purchase government securities. Others argued that the Accord would lead to perverse outcomes, because banks would be tempted to make riskier, high-yielding loans in order to compensate for the cost of holding more capital against all loans. Still others proclaimed that the Accord would lead to a "credit crunch," by curbing lending activity on the part of major banks. Finally, the various criticisms aired earlier about competitiveness circulated once again.

This section analyzes some of the implications of the Accord for bank safety and soundness, on the one hand, and for bank competitiveness, on the other. Because the Accord does not become fully applicable until the end of each bank's 1992 fiscal year, any evaluation must, of course, be provisional. Further, commercial banking is in the midst of another period of turmoil with the downturn in real-estate markets, the stock-market decline (especially in Japan), the savings-and-loan crisis in the United States, and ongoing debate over revisions of existing banking legislation in the United States, Japan, and Western Europe.

##### *Safety and Soundness*

The primary task of bank supervisors is to ensure the safety and soundness of the banking system, and it is in this light that the Basle Accord must first be evaluated. According to Peter Hayward (1990), secretary of the Basle Committee, "the purpose of the capital agreement was to strengthen the capital base of the banking system." The presumption behind this remark is that there is a direct relation between levels of capital and bank soundness, because highly capitalized banks have greater resources available for absorbing unexpected losses.

Indeed, since the announcement of the Basle Accord, it is fair to say

that “capital” has become the most important word in the bank regulators’ lexicon. The 1990 U.S. Treasury proposal for banking reform, for example, was largely based on the foundation of capital adequacy. Highly capitalized banks would be permitted to engage in a number of new activities (underwriting securities, for example) that would remain closed to those with low capital levels (U.S. Treasury, 1991). Recapitalization of the banking system has become the primary objective of central bankers and other regulators.

Although economists have found no correlation between bank capital levels and bank failures (Swary, 1980; Maisel, 1981), it is difficult to argue with the proposition that higher capital levels increase safety and soundness. First, bank capital provides assurances to depositors, who might feed a run on an unsafe bank by withdrawing their funds, even in the presence of deposit insurance. Second, capital serves to absorb unexpected losses; if the levels of capital are greater than the historic levels of unexpected losses, the bank can be expected to weather downturns in particular sectors or the effects of occasional bad lending decisions.

In the context of the developing-world debt crisis, however, these arguments would appear to be less compelling. After all, bank exposure to third-world debt was a large multiple of bank capital, and doubling or even tripling capital levels would do nothing to prevent insolvency in the face of massive repudiation. But the strategies adopted in 1982 and 1983 for dealing with the debt crisis, including the capital-adequacy standard, have indeed “bailed out the banks,” in that they have managed to keep the international payments system working. By providing liquidity to the debtors, and thus ensuring that banks would continue to receive some interest on their loans, governments made it possible for banks to raise fresh equity; indeed, by establishing stiffer capital-adequacy standards, they required banks to do so. After 1985, banks were strengthened to the point that large loan-loss reserves could be established, aided by changes in tax and accounting laws (Bird, 1989). This development has, in turn, encouraged the debtors to adopt many of the economic reforms advocated in the Baker and Brady plans and by the IMF and World Bank, because they recognize that commercial banks are no longer obliged to keep lending them money in order to preserve the myth of solvency, as was the case in the early 1980s. In short, the Basle Accord must be judged in terms of the larger policy project of managing the debt crisis and maintaining the international payments system.

Although the Accord becomes official only at the end of fiscal year 1992, the response of the financial marketplace has been surprisingly

swift. Banks have been raising capital and/or shedding assets, and they have already sought to advertise their strength in terms of the Basle standard in their annual reports, publicity, and publications. Most of the international banks at which the agreement was targeted have already proclaimed that they meet the 1992 capital levels.

Bank strength, however, is ultimately a function of profitability, and in this the outlook for banks remains unclear. International business for the banks has been sluggish, and the Japanese in particular have retreated to focus again on domestic markets. American banks have emerged from the debt storm only to face a massive real-estate crisis and the potential for severe losses in their leveraged-buyout portfolios. Given the continuing problems facing the over-banked financial system, it is not surprising to find that the supervisors who meet at Basle are now focusing on measures of bank liquidity. Higher capital levels may restore public confidence in the ability of banks to withstand losses, but they will do little to make banking a profitable industry.

#### *Competitive Effects*

I have argued here that the Basle Accord seeks to strengthen the banks' capital positions in a manner consistent with a fair international competitive standard. As with its effects on safety and soundness, an analysis of its competitive effects must look in two directions. Bank supervisors have now made it clear that high leverage is not an acceptable basis for gaining market share, and there must be some leveling of the playing field to the extent that capital levels converge. To the extent that national regulators are free to strengthen bank capital levels and standards beyond those agreed upon at Basle, however, the possibility remains that regulatory discretion at the domestic level will disadvantage certain commercial banks. It should be noted that differing capital levels are hardly the sole basis for international competition in financial markets, so the Basle Accord does little to make all financial institutions equal.

The Accord has three parts, each of which is subject to the right of national regulatory authorities to interpret the agreement so long as the capital-adequacy standards are met or exceeded. These are the definition of capital, the application of risk weights to specific asset categories, and the treatment of off-balance-sheet activities. Differences in national discretion are particularly marked with respect to the definition of capital and the application of risk weights to specific asset categories, and a continuing issue for the Basle Committee will be whether or not national interpretations are in fact consistent with the spirit, if not the letter, of the Accord.

The potential for conflict among national regulators and between banks and their supervisors should not be dismissed. The concern of observers with implementation arises from the fundamental assumption that a country's banks will be placed at a relative disadvantage, at least in the short run, if national regulators interpret the Accord in a comparatively stringent manner. The banks of such countries will be forced either to raise more capital or to shed assets to meet target ratios. Those that do neither can be prevented from opening new branches or expanding into new geographic or product markets. Hence, banks in the tougher countries will face a painful period of adjustment.

Conflicts could arise in interpretations on both the asset and liability sides. With regard to liabilities, it will be recalled that the Accord divides capital into tier-one and tier-two capital. The overall capital level to be achieved by the close of fiscal year 1992 is 8 percent, of which 4 percent must be tier one. Although there is no discretion regarding the definition of tier one (it must be shareholders' equity), national regulators are given considerable leeway in determining what constitutes tier two. The greater the diversity of items allowed by a country's regulators into tier two, the easier it will be for their banks to meet the Basle standard.

With regard to assets, the underlying theory of the Accord is that the amount of required capital should depend on the credit risk associated with the bank's asset portfolio, including its off-balance-sheet activities. Risk weights are thus assigned to all assets, meaning that different levels of capital are required to support different types of assets. The possibility of a face-off between commercial bankers and their supervisors is made apparent by a simple example. Supervisors in the United States and Japan, for example, place a zero weight on banks' holdings of claims on all OECD governments; no capital is required to support these assets (fueling the criticism that the purpose of the Accord is to finance government deficits). The Bank of England, in contrast, places a 10-percent weight on some government securities and a 20-percent weight on others. All things being equal, British banks would have to raise more capital to hold the same portfolio of assets, and we might thus expect British bankers to cry foul.

Yet another area for national discretion is the applicability of the regulations to the various classes of financial institutions. The Accord applies to "international banks," with no further attempt at definition. The Japanese have interpreted this to mean banks with "significant international banking activities," namely, those with branches or subsidiaries overseas. Thus, a Japanese bank that maintains only agencies or



representative offices in the United States would not be subject to the Basle requirements. The Federal Reserve Board, in contrast, has elected to apply the risk-based capital regulations to all banks and bank holding companies that it regulates. Because the OCC and FDIC have also agreed to apply the Accord to the institutions they supervise, coverage of U.S. commercial banking will be nearly complete. The Bank of England is also applying its regulatory regime across the board. Again, differing interpretations could become a source of tension if Japanese representative offices appear to take competitive advantage of their exemption from the Accord's provisions.

#### *Implementation Issues*

The Basle Accord leaves many commercial banks with no choice but to raise equity and/or to shed assets. Both of these strategies face hurdles. Securitization of assets may provide a partial solution, as it can be used to eliminate from bank balance sheets those assets that are fully weighted. But not all assets can be securitized, and, if too many banks try to sell those assets that can be packaged and sold, the prices of the assets will drop. Further, to the degree that securitized loans are bought by institutional investors who could have bought bank shares instead, the banks are denied a potential source of equity (Bleakley, 1990).

Securitization has also become a political issue in those countries that, like Japan, previously prevented commercial banks from following the practice. For securitization to occur in Japan, Japanese laws must be changed, and the question of who may be allowed to deal in such securities must be resolved. The outcome of the debate in Japan could have far-reaching implications, for Japanese investors are viewed by non-Japanese banks as a potentially large market for their securitized assets (*The Economist*, 1990b).

Raising equity will be no easier than shedding assets. As a *Wall Street Journal* (October 9, 1990, C1) headline announced in 1990, "Banks Find their Sources of Capital are Drying Up." The recession in the United States, the explosion in problem loans, and the continued loss of markets to other providers of financial services have all conspired to discount the value of bank shares. By late 1990, many banks were cutting dividends and shedding workers in a belated effort to control costs. Although these were important steps, they did nothing to improve the long-term outlook for bank profitability.

The global stock-market decline and rise in the value of the dollar that accelerated following Iraq's invasion of Kuwait in August 1990 compounded the banks' difficulties, especially outside the United

States. Japanese banks had counted on the revaluation of their equity holdings to make up a large part of tier-two capital, but, between January and October 1990, the value of the Tokyo Stock Exchange dropped by more than 40 percent. American banks have not been immune either. The global stock-market decline has made raising tier-one capital more difficult, and the banks' continuing problems caused the shares of such money-center banks as Citicorp and Chase Manhattan to decline by more than 50 percent between the summer and autumn of 1990.

The Basle Accord poses yet a different set of concerns for bank customers. So-called middle-market firms, companies with annual sales of \$25 to \$100 million, are particularly worried, because the risk-weighting system favors bank asset allocation toward cash and government securities and away from loans. Given the new capital requirements, banks would have to earn a healthy spread on middle-market loans to make them profitable, and they have not done so in recent years because of intense competition for this market segment. Unfortunately, these middle-market firms—unlike large, Fortune 500 corporations—are relatively dependent on banks for their financing, and a credit crunch would hurt them disproportionately. Since small and medium-sized firms make substantial contributions to new investment and job generation, the implications of reduced financing for these companies is worrisome.

A provisional assessment of the Accord, then, suggests that its promise to increase safety and soundness in a manner consistent with fair competition will be met, but not completely or without costs to the banks themselves and their customers. Although it is certain that central bankers will disagree over national interpretations of the agreement, these disagreements will in all likelihood be peacefully resolved in the Basle Committee. Indeed, a major activity of the Committee as of this writing is to iron out disagreements over interpretation and implementation. By the end of fiscal year 1992, depositors, bank analysts, and regulatory officials should have at their disposal a single standard by which bank capital can be evaluated.

It would be a mistake, however, to look at the Basle Accord only in terms of safety and soundness or of competitiveness. Fundamentally, the Accord represents a policy effort to set rules for a greatly altered international payments system. Although there is legitimate room for debate about the means employed to advance the Basle Accord—basically threats of market closure by the United States and Great Britain—there is little argument over the importance of the ends. A

smoothly running international payments system is a public good, and each country that enjoys its use also has a responsibility to contribute to its maintenance. To the extent that higher capital levels bolster confidence in international banking, the Basle Accord must be viewed as a welcome development.

## 5 Concluding Remarks

The competitive advantages and disadvantages associated with the Basle Accord's provisions will never become an issue if the capital requirements are not enforced. Implementing a multilateral agreement, however, will prove challenging. The credibility of the regulators' main enforcement weapons, such as cease and desist orders and civil penalties, remains in doubt, and it is unclear how stringently they will be applied to banks that fail the Basle test in the United States and abroad.

Assisting the Committee in its work, however, is the marketplace. If nothing else, the Basle Accord has established a capital-adequacy *standard*, and financial analysts are assessing banks in terms of that standard. As the Basle supervisors wrote in a 1990 report, "the market itself has imposed its own discipline. Banks have found a distinct advantage in being able to satisfy the rating agencies and the market generally that their capital was adequate in terms of the final Basle standard. . . ." (Basle Committee, Annual Report, 1990). To the extent that market and regulatory forces are reinforcing, positive incentives will exist for banks to meet the Basle requirements as quickly as possible.

One frequently mentioned criticism of the Accord concerns its applicability. It is said that, because the capital-adequacy standards must be met only by banks based in G-10 countries (and the EC, which has more or less incorporated the Basle capital requirements into its recent banking directives), they will be disadvantaged in competition with "offshore" international banks, and those of Australia, Hong Kong, Singapore, Korea, and the countries of the Middle East. Sensitive to this allegation, the Basle Committee has carried out intensive discussions with bank supervisors in these and other countries to ensure that they understand the purpose of the agreement and its implications. Indeed, many countries outside the G-10 have already signaled their acceptance of the Basle standard (Basle Committee, Annual Report, 1990).

Yet, a number of systemic political and economic forces lie beyond the Committee's reach, and these could make it extremely difficult for banks to meet the Accord's provisions. The overall decline in stock-

market values, and the decreasing value of money-center bank shares in particular, are impeding banks that seek more tier-one capital. In this economic climate, asset shedding will also prove challenging.

Given the environment for commercial banks, it is not surprising to find executives suggesting radically new approaches to reshape the financial sector. The chairman of Citicorp, John Reed, has suggested the creation of strategic alliances between major banks or the ownership of commercial banks by industrial concerns, both of which could lead to higher capital ratios. Although current legislation in the United States prohibits commercial banks from implementing some strategies, Reed's comments suggest that the demand for bank capital could someday force significant legislative changes.

Indeed, it is entirely plausible that the Basle Accord may in hindsight be viewed as having heralded an era of banking consolidation and structural change, especially in the United States. Several major bank mergers have been announced in 1991 alone, including that between two of the most important money-center banks, Chemical and Manufacturers Hanover Trust. In the words of a Federal Reserve Board official, "the plain fact is that in the current environment we need a leaner and more efficient banking system" (cited in Duke and Hilder, 1990). Higher capital levels can certainly contribute to the process of shrinking the over-banked American financial system.

At the same time, the restructuring of the banking system in general, and the making of international regulations in particular, raise profound questions of democratic control and domestic politics. It is well to remember the storm created in 1987 by the then undersecretary of the Treasury, George Gould, when he stated his preference for an American financial system characterized by five or ten giant banks that could rival those of Western Europe and Japan. Gould admitted that "any policy promoting the creation of very large financial institutions encounters deep-seated sentiments that date to the founding of the Republic" (Nash, 1987).

International regulations that promote structural change are also likely to antagonize "deep-seated sentiments." In Western Europe, the question of a "democratic deficit" has already emerged, as an increasing number of important political and economic decisions are being taken by the European Commission in Brussels. The question of political accountability looms large as decisionmaking shifts from national legislative and executive bodies to international organizations.

These larger questions, however, still remain on the distant horizon when it comes to international finance. For the time being, the Basle

Committee provides a useful forum for airing and resolving disputes among G-10 regulators and for seeking better methods of supervision in an increasingly complex international economic environment. Nevertheless, as the BCCI case has so powerfully revealed, the Committee is not a supranational organization, and it has no enforcement powers on its own. Banking supervision still remains the province of national authorities, and the Committee is only as effective as its member states want it to be.

Indeed, without the exercise of American power, a capital-adequacy accord might not have been reached. By extension, this suggests that international regulatory agreements are most likely to come about when a great power seeks them for domestic reasons. The larger implication is that the international economy is not simply a manifestation of markets at work but also of state policies and preferences.

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