Financial Markets and Systemic Risk; the response of central banks in the 1960s and 1970s

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One of the major rationales for regulating banking systems and financial markets is the threat of systemic crisis should one ‘bad apple’ collapse. This is due to the combination of fractional reserves, the uneven liquidity of assets compared to liabilities, and information asymmetry involved in financial intermediation that can preclude customers from gaining sufficient information about their banks, and bankers from gathering sufficient information about their customers to make markets operate efficiently. The failure of one institution due to fraudulent or imprudent behaviour may then lead to irrational herding behaviour as panic spreads through the banking system affecting otherwise sound institutions. As the Great Depression showed, such systemic crises in international banking may have macroeconomic as well as microeconomic consequences that make *caveat emptor* or reliance purely on market forces to clear out inefficient actors too costly for governments to tolerate. This rationale has been the foundation for prudential supervision and regulation of national banking systems in most major banking centres, ranging from official supervision and transparency rules to lender of last resort and deposit insurance. The international corollary of national prudential regulation as the globalisation of finance intensified should have been international or supra-national supervision of international banking, but in practice this has not been effectively achieved. An examination of the 1960s and 1970s, when the possibility of a coordinated response to international systemic risks was debated and contested helps to show the longevity of the obstacles to coping with international systemic risk in a globalized international financial market.

The major systemic risk for states in the 1960s was exchange rate risk. After the end of the Bretton Woods system, this preoccupation gave way to the risk of systemic international bank failures in the 1970s, and then sovereign debt crisis in the 1980s. Dealing with exchange rate risk was an issue that was tackled at various levels. National politicians at the highest level were directly involved in protecting the exchange rate regime because it was identified as a signal of the government’s policy success. Central bank cooperation through international swaps and lines of credit were used in a pre-emptive way to enhance market confidence as well in a responsive way to provide resources to defend exchange rates under speculative pressure. The Gold Pool from 1962-68 also sought to stabilise exchange markets through internationally coordinated direct intervention. All major states also attempted to restrict their vulnerability to exchange rate risk by insulating domestic monetary systems from short term international capital flows through exchange controls, discriminatory tax regimes and prohibition of interest on non-resident deposits. National responses, however, were not enough since persistent deficit countries were not able to correct their underlying economic weaknesses. The props for the system that were developed to hold it together while a longer term solution was devised ended up as the only bulwark against the speculative pressures of the market, and they finally gave way with the change of attitude of the US administration toward international cooperation in the early 1970s.

While preventing runs on national currencies was the primary financial risk facing national governments in the 1960s, acceleration of the globalisation of the international financial market in the early 1960s prompted central bankers to begin to devise strategies to deal with systemic risk from international bank lending. The debate over regulating the Eurodollar market highlights the contrast between European attitudes to capital markets compared to the views of the USA and the UK. The archival evidence shows that there were lively concerns about the dangers of the market and vigorous internal discussion about intervention as well as regulation in both London and Washington, and also among banks themselves. Nevertheless, both American and British regulators resisted introducing controls because the benefits of the market for their balance of
payments outweighed the systemic threats. This is not to say that the British and Americans were opposed to capital controls per se. Indeed, this was a time of deliberate intensification of capital controls in the USA on US$ outflows, and in the UK on sterling transactions. However, they both took the position that regulation was a national rather than an international concern and that protection from systemic risk was up to each country through its own exchange control tools. A small crisis in the Eurodollar market in 1963 was not enough to persuade them of the need for collaborative efforts. Even after the more serious international banking crisis of 1974, there was a lack of institutional will to subvert national systems to international standards. Only after the 1982 LDC debt crisis and the first Basel Accord in 1987 was there a consensus, and this proved to be too reactive to protect the international financial system from the series of financial crises in the 1990s, culminating most damagingly in the Asian Financial Crisis of 1997.

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

The Bretton Woods Era Capital Controls: 1950-1973
The regulation of international financial markets in the 1950s and 1960s was closely linked to the Bretton Woods solution to the ‘trilemma’ or ‘impossible trinity’, which explains that maintaining policy sovereignty in the context of fixed exchange rates requires imposing limits on international capital flows. The over-riding goals of national economic growth and full employment as well as the development of welfare states after 1945 required that national sovereignty was prioritised over freer capital flows. Countries with balance of payments deficits used direct controls on outflows to avoid relying solely on higher domestic interest rates. Conversely, countries with pressures for surplus and inflation used regulations to protect their domestic monetary systems from inflows of capital.

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

The 1960s and early 1970s marked the high point for the intensity of capital controls globally. Trade controls were no longer deemed acceptable to protect national sovereignty but controls on capital were considered a useful tool that had limited political fallout because those directly affected were faceless financiers or ‘gnomes of Zurich’ rather than consumers. Even after the collapse of Bretton Woods, the international consensus remained firmly in favour of capital controls as the first choice to protect the balance of payments. However, with new challenges posed by the collapse of the international monetary system, these controls bred financial innovation and the rise of offshore capital markets. There was no consensus on imposing further controls on offshore markets, and so the Bretton Woods solution to the trilemma collapsed despite the intensification of national capital controls. The next section describes the debate over controlling the Eurodollar market.


*The USA and the UK*

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

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

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

The US Treasury agreed with the Bank of England that there was no need for external supervision or new regulation of the Eurodollar market. The under-secretary of state for monetary affairs, Robert Roosa, told Parsons of the Bank of England early in 1963 that he ‘was certain that the Eurodollar market would continue to be a feature of the international financial situation. It was potentially a vehicle for instability but also an important part of liquidity’. Less than a month later, Roosa told S. Goldman of the UK Treasury that he already had some talks with one or two representatives of the banking community and reminded them that although there is no question of imposing exchange control, they should, in his [Roosa’s] words, ask themselves whether they are serving the national interest by participating in this sort of activity, which adds to the volume of short term capital outflow from the US. Mr. Roosa was not too optimistic about the outcome.

Roosa was not as positive about the prospects of moral suasion being exercised effectively in the New York market as the Bank of England was in London. However, in 1963 several major US and European banks did agree among themselves to restrict the inter-bank market and avoid ‘pyramiding’ of deposits because of fears over the market’s stability. At the end of November 1963, a fraudulent food oil scam in the USA brought down the NYSE broker Ira Haupt and generated a series of defaults on Eurodollar loans that amounted to about US$100m in losses shared among several major US banks. The losses were well within the provisions made by the banks and there was no systemic crisis, but the defaults did send a shock through the market and brought monetary authorities back to the question of regulation and supervision. The increasing volume of short-term inter-bank flows seemed to echo the financial crisis of the 1930s, but it did not lead to a reversal of the toleration of the market. In London, the system of informal supervision continued. As Cromer told Holtrop of the BIS, ‘if in an individual case it appeared to us that an unsound situation was developing, we would then discuss the matter with the bank in question’. Governor Daane of the Fed worried about the possibility that ‘unsound lending’ might lead to a chain of defaults that would cause a banking crisis similar to that of 1933. He was reassured, however, by arguments that the Eurodollar market represented a small proportion of banks’ total liquidity and that the market was sensitive to geographical concentration. Like the Bank of England, the Fed used its contacts to obtain more information about the market by asking a small number of leading US corporations why and how they used the Eurodollar market, but they did not put any obstacles in the way of such transactions.

Through the early 1960s the US Federal Reserve considered ways to insulate the US economy from the Eurodollar market ‘by prohibition or patriotic persuasion’ or by altering incentives or reserve requirements. By 1967, they concluded that

a) ‘Prohibition might stimulate innovation in methods of avoidance.'
b) Efforts at persuasion might bring counter-productive psychological reactions.

c) It would not be sound policy to make what might have to be a permanent change in the framework of reserve requirements for transitory reasons.\(^{26}\)

As with the US Treasury, the Fed did not put as much weight on the effects of moral suasion as did the Bank of England. If the Fed wanted to support an integrated world money market, they could not introduce new reserve requirements on foreign deposits of US banks abroad. On the other hand, reserve requirements would ‘help us to manage domestic monetary policy effectively – and, incidentally, help simplify other people’s management of their domestic and external monetary policies’. Two years later, the Fed opted for domestic priorities and in September 1969 imposed a 10% reserve requirement on net liabilities to foreign branches of US banks in excess of the average amounts outstanding in May 1969. This discouraged foreign branches of US banks from repatriating US$ to their head offices and thus undermining US tight money policy. The Fed estimated that 30% of foreign branch resources were used to supply parent offices in 1969 but that in 1970 this had reduced to 2.7%.\(^{27}\)

At the beginning of 1968, the Fed Board considered whether to intervene to hold down Eurodollar interest rates by providing additional funds to the market through the Fed-BIS swap mechanism.\(^{28}\) As part of this study, it was revealed that the Fed had intervened in the market in the recent past, but by 1968 most in the Fed were against any further action. In April, the Fed publicly acknowledged that the Eurobond market was an integral part of their balance of payments policy: ‘It has always been clear that part of the required adjustment in international payments would have to come through increased European financing of capital investment in Europe and elsewhere’.\(^{29}\) In 1968 new issues of securities in foreign markets by US corporations soared to $2.1b from $US450m in 1967.\(^{30}\) The US money supply was insulated from the market by reserve requirements in 1969 but offshore borrowing of US$ by foreign companies was encouraged to ease the pressure on domestic capital markets.

Although taking steps to insulate the US economy, the USA did not push the Bank of England or UK Treasury to impose controls in London. The official view was that the US economy was vulnerable to short term capital movements of many kinds including the Eurodollar market, and that this problem could not be contained effectively through further restrictions. On the plus side, the market had increased overseas borrowing of US$, thus relaxing pressure on the New York market directly. By 1970, the view of the President’s National Advisory Committee on International Monetary Affairs was that the market was a symptom rather than a cause of instability between national markets:

‘it would not be possible to achieve tight controls on the access of US banks, companies, or investors to foreign short term financial markets (including the Eurodollar market). Moreover, a network of controls could not be spread very far or imposed very tightly without impairing the freedom of action for traders and investors that the basic convertibility of currencies is designed to promote…Thus it is not clear to us that control of the Eurodollar market is an appropriate step in the solution of either balance of payment problems or domestic liquidity problems, created by the rapid movement of capital in response to differences in national monetary policies or speculative incentives.’\(^{31}\)
This section has examined the regulatory response of the supplier and the host of the Eurodollar market. The financial innovation had not been anticipated and reaction was slow in London. The cozy informal networks that had developed in London from the 19th century encouraged the Bank of England to continue to rely on personal contacts and ‘moral suasion’ despite the fact that the market was changing dramatically with the arrival of US banks. The US Fed was uncertain about the impact of the market on their balance of payments, but found London’s facilities eased domestic pressure to relax capital controls and tight money. Both sets of regulators at this point also recognised that this innovation marked a new era of complexity in international finance that was no longer as amenable to national controls. Moreover, the Bank of England was clearly sensitive to the dangers of regulatory competition between international financial centres. Driving the market to a less well regulated centre was not in the interests of the UK, nor of the overall stability of the international financial market. The over-riding priority for both governments, however, was minimising balance of payments deficits and the market had a role to play in this campaign on both sides of the Atlantic.

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

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

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

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

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

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

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

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

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

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

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

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

**Multilateral Supervision of Multinational Banks 1974-1990**

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

With the advent of floating exchange rates, at the beginning of 1974 the USA relaxed capital controls, prompting a significant capital outflow and rapid depreciation of the US$ that caught out some foreign exchange dealers. Doubts about the soundness of many new small and medium-sized banks in the Eurodollar market prompted the emergence of a tiered interest rate structure in the spring and summer of 1974. Small banks faced a liquidity squeeze as the market contracted, causing the failure of the Herstatt Bank. The market panicked and the rate on three-month Eurodollar loans soared to an unprecedented 14% in mid-July. At the end of September the New York Reserve Bank had to take over the foreign exchange obligations of Franklin National Bank. The contrast between the willingness of the Bundesbank to allow the failure of the Herstatt and the Fed’s support of the Franklin highlighted the inconsistency of
international practices of lender of last resort. The Bank of England took the position that it had no responsibility for the solvency of subsidiaries of foreign banks in London and so the Israel-British Bank was allowed to fail in July 1974 with outstanding debts of £43m.\(^{57}\)

Ten years after the American ‘invasion’ of the city of London, this crisis prompted efforts to co-ordinate lender of last resort facilities to international banks to prevent systemic crisis. In September, the Central Bank Governors of the G10 announced that, although detailed rules governing lender of last resort to the eurodollar market were not practical, the market should be reassured that ‘means are available for that purpose and will be used if and when necessary’.\(^ {58}\) They also set up the Committee on Banking Regulations and Supervisory Practices in Basle, chaired first by George Blunden and then by Peter Cooke, both of the Bank of England.

While international regulation stalled, national regulatory changes went ahead. In the City, the Bank of England urged consortium banks to set out formally in letters to the Bank of England that their shareholders would agree to act as lenders of last resort. Foreign banks were asked similarly for commitments that they would support their UK subsidiaries, although these undertakings were not enforceable.\(^ {59}\) At the same time the Fed announced that it was ready to act as lender of last resort for member banks to protect them against abrupt withdrawal of petro-dollars or any other deposits. Together, these measures reassured the market and the tiered interest rate structure contracted early in 1975 as confidence returned.

In addition to the traditional personal meetings with individual bank officers, London banks had to make more detailed and continuous statistical reports to enhance prudential supervision. At the end of 1974, the Bank of England sent a letter to all banks in the City advising them to tighten up their internal control systems, in particular with respect to the control of foreign exchange operations by branches and subsidiaries overseas. This was the first time such a formal and public instruction had been made. The Bank of England also required London’s British Overseas Banks for the first time to report the activities of their overseas offices. Blunden noted that ‘the reaction of most banks to our letter has suggested to us that we were right in judging that the banking community as a whole was ready for us to take this new line.’ Blunden, nevertheless, promised ‘our approach remains flexible, personal, progressive and participative.’\(^ {60}\)

The Basle Committee on Banking Regulations and Supervisory Practices issued its Concordat in 1975 setting out the supervisory responsibility for multinational banks, concluding that solvency of foreign branches was ‘essentially a matter for parent supervisory authorities’, while foreign subsidiaries and joint ventures lay within the responsibility of the host authorities.\(^ {61}\) The subsequent recommendation of 1978 that solvency should be based on consolidated accounts put greater emphasis on parent authorities than on hosts to ensure the collection and publication of this information. The Concordat was further amended in 1983 to emphasize the need for cooperation and communication between host and parent supervisory bodies, which was elaborated in recommendations in 1990. The collapse of BCCI led to renewed calls for supervision of multinational banks and the Concordat recommendations were formalised into minimum standards in 1992, but enforcement was still problematic. The 1992 amendments put more emphasis on the host to ensure that the parent country had adequate supervisory structures. Banks were to seek permission for cross border expansion from both host and parent regulators. These amendments further emphasized international information flows, but by 1996 the BIS recognised that information was not passing easily from some hosts (particularly off-shore financial centres) to the parent supervisory bodies.
The Basle Committee also considered how it could help with risk management, perhaps through central agencies that collected information on total liabilities of particular borrowers that could be accessed by potential additional borrowers. In the late 1970s, as in the early 1970s, the problem of customer confidentiality and the different standards of disclosure among the various jurisdictions made this impossible. In 1977 a proposal by Arthur Burns, Chairman of the Fed, to collect information on the direction and volume of international bank lending met strong resistance from banks, who viewed this as unnecessary meddling in their affairs. Instead, the BIS reported quarterly data on countries’ total external debt and from 1978 included maturity distribution on a half-yearly basis. From December the Bank of England began to publish the consolidated exposure of banks in the UK. In May 1982 the Basle Committee finally agreed on guidelines on country-risk for banks to consider – just in time for the LDC debt crisis.

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

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

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

At the end of 1987 the Basel Committee issued a consultative paper on capital adequacy with minimum standards for international banks. The focus of their deliberations arose from the major preoccupation at the time; sovereign default risk. The Committee assigned weights to different categories of asset and proposed that carefully defined capital should be at least 8% of the weighted assets. After six months of consultation the proposals were adopted with some minor changes and were implemented by many banking regulators by 1992. The failure of the Capital Adequacy Requirements to forestall the series of financial crises in the 1990s from Mexico to Russia, led to a reassessment of risk weightings, in particular since they had been designed mainly with sovereign risk in mind (since this was the problem of the 1980s) rather than risk of private borrowers (which was the case in the Asian Financial Crisis). Basle II also emphasises prudential supervision and better disclosure.

Conclusions
This analysis has highlighted the response to systemic risk among central bankers by focussing on the Eurodollar market and multinational banking in the 1960s and 1970s.
These cases reveal the longevity of current obstacles to cooperative international efforts. International finance has remained regulated on a national basis because of practical obstacles to information flows and the dangers of pushing markets to more fragile and poorly supervised off-shore centres, as well as an ideological lack of consensus over the costs and benefits of globalisation, and the perceived threat to national sovereignty. These obstacles to cooperation derive from the origins of 20th century globalisation and were as apparent in the 1960s as they have been over the last decade. Efforts at cooperative or collaborative supervision and regulation are most commonly found after a crisis when an international event has threatened national financial systems. As these crises recede, so does the impetus for regulatory reform. This pattern has also meant that central bankers are analogous to generals always preparing to fight the last war instead of looking forward to new challenges.

The historical case of the regulation of the Eurodollar market in the 1960s and 1970s shows how the unwillingness of the host of the market (in this case London) to accede to calls for controls from other national regulators eliminated the possibility that any such controls would be introduced. In the 1980s and 1990s, new offshore ‘brass plate’ international financial centres continued to foil efforts to impose cooperative supervision. The early debate over the Eurodollar market also reveals how uncertainty about the impact of financial globalisation prevented a clear consensus about the advantages and disadvantages of supervisory regulation, further hampering efforts at multilateral or supranational level. This was the antecedent to the much more public debate about the benefits of globalisation in the 1980s and 1990s.

International finance became extraordinarily more complex and surged in volume relative to ‘real’ economies in the 1980s and 1990s. However, the seeds of the basic obstacle to cooperative efforts at prudential regulation were already apparent in this earlier era of financial innovation. These debates set the precedent for the priority of national over collective interest in the absence of clear evidence that globalisation threatened systemic failures.
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8 Anne Kreuger, Director of IMF on 9 December 2003 speech in Malaysia.


10 Rajan and Zingales, *Saving Capitalism*, p. 262.


13 For an account of the protests from the City over these controls see Schenk, ‘The New City And The State’.


16 Memo of meeting of Roosa with Rickett (HMT) and Parsons (BE), 9 April 1963. NARA, Papers of under secretary of state for monetary affairs, Box 106, RG69-A-407.


20 Note by Preston to Bridge, circulated to Selwyn, O’Brien and Parsons, 4 December 1963. BE EID10/22.
21 Bridge to Parsons and O’Brien, 5 December 1963. BE EID10/22.
23 An example was the inability of Italian banks to borrow in the market in November 1962. Note by Henry N. Goldstein for Mr Young, 17 February 1964. NARA, RG82 Box 76.
24 Note for the files by Alfred Hayes re: Conversation with W Braddock Hickman, President of the Federal Reserve Bank of Cleveland, 13 April 1964. NARA RG82 Box 76.
25 John E Reynolds to Katz, 8 January 1968. NARA RG82 Box 76.
28 Informal record of a meeting on the Eurocurrency market held at Netherlands Bank on
30 Informal record of a meeting on the Eurocurrency market held at Netherlands Bank on 18/2/71. Chaired by Ziljstra. BIS, GILB1.
31 The involvement of the BIS in the discussions over the Eurocurrency markets is described G. Toniolo, Central Bank Cooperation at the BIS 1930-1973 (Cambridge, 2005), pp. 465-471.
32 Short paper by BIS as basis for discussion at meeting of experts on 6-8 October 1962, 31 August 1962. BIS, 1/3A(3) Meeting of Experts, Volumes 1-2.
33 The Americans were particularly keen to see the BIS collect data on the market to help them trace its movements and potential impact on the USA. Fred H. Klopstock, Manager Research Dept of FRBNY to M Gilbert, 28 May 1962. BIS, 1/3A(3) Meeting of Experts Volumes 1-2.
34 Informal record of a meeting on the Eurocurrency market held at Netherlands Bank on 18/2/71. Chaired by Ziljstra. BIS, GILB1.
35 Antonio D’Aroma Secretary General BIS, note of experts’ meeting on Friday 9 April 1965, drafted 15 April 1965. BIS, FER8 7.18(10).
36 On the failure of this proposal see also Toniolo, Central Bank Cooperation, p. 469.
37 Informal record of a meeting on the Eurocurrency market held at Netherlands Bank on 18/2/71. Chaired by Ziljstra. BIS, GILB1.
38 For a survey of the contemporary debate see Hawley, ‘Protecting’.
39 Second meeting of the Standing Committee on the Eurocurrency market. 1 June 1971. BIS, GILB1.
41 Toniolo relates briefly how the disagreements about both the disease and the cure continued. Toniolo, Central Bank Cooperation. P. 466-67.
42 Eurocurrency Standing Committee, Informal Meeting 8 January 1972. BIS, GIL1.
43 Eurocurrency Standing Committee, informal meeting 4 April 1972. BIS, GIL1.
44 Larre in the Chair noted that not all EEC countries were in favour of monetary union. Informal record of Eurocurrency standing committee meeting, 8 July 1972. BIS, GIL1. The same views are recorded in Informal Record of Eurocurrency Standing Committee Meeting 6 January 1973. BIS, GIL1.
45 AD Crockett note for files on Committee of 20 meeting 26 March 1973, Archive of the International Monetary Fund [hereafter IMF], G142.32 C-20 Ministerial Meetings. Informal record of Eurocurrency Standing Committee Meeting, 9 December 1972. BIS, GIL1.
Informal record of Standing Committee on Eurocurrency Markets Meeting, 9 September 1972. BIS GIL1. The Fed would have preferred banks to keep their deposits direct with the USA.


Foreign exchange trading losses amounting to over US$100m, as against deposits of US$760m. Reid, *Secondary Banking Crisis*, 115. Wilson, *The Chase*, 213.


By the end of February 1975 all consortium banks had given such an undertaking.


Quoted in Johnson and Abrams, *Aspects*, 16.


James, *International Monetary Co-operation*, 321.


At the same time the European Commission was drawing up common European banking standards.