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Financial Institutions in the International Monetary System

by Jonathan David Aronson*

I. INTRODUCTION

TREATISES ON INTERNATIONAL monetary economics generally stress the operation of market forces and belittle the importance of market institutions. The activities of financial markets are examined; the intervention of finance ministries and central banks is deplored; the influence of private financial actors is ignored. Economists usually assume that the private pursuit of profits has little effect on monetary crises or monetary reform. Therefore, economists regard recent changes in the role of private financial actors as irrelevant and disregard financial intermediaries’ expanding influence over the calculus of international monetary politics. Policy efficiency suffers.

This essay examines the evolving role of commercial banks within the world monetary system since 1970. It then explores possible effects of transnational banks and insurance enterprises on the operations of the monetary system. Finally, it speculates on the importance of current changes in financial and industrial structure for the management of monetary crises and monetary reform.

II. BANKS AS INTERNATIONAL MONETARY ACTORS

Most adults believe that bankers are rich and therefore are powerful. They assume that wealth is translated easily into political influence. Sometimes this assumption is correct, sometimes not. For example, in the 1920s the House of Morgan actively assisted in the restabilization of European currencies and the National City Bank and the Chase National Bank participated in and benefited from American dollar diplomacy.1

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2 Id. There is a partial exception for works which deal with North-South relations and focus on trade, aid, and investment.

However, banks retreated from the political limelight in the 1930s, uncertain of their goals, distrusted by politicians and society, and shackled with new regulations designed to prevent the last depression.\footnote{Of particular importance was the Glass-Steagall Banking Act of 1933 which widened the authority of the Federal Reserve Board, prohibited banks from paying interest on demands, separated commercial and investment banking, and created the Federal Deposit Insurance Corporation. H.R. 5661 Publication No. 66 June 16, 1933.}

In this atmosphere, the political economy of Adam Smith and J.S. Mill faded from view, replaced by the new Keynesian economics. J.M. Keynes' interpreters believed that national economies and the world economic regime could be successfully managed by governments and international organizations.\footnote{Keynes has often been misinterpreted. H. MINSKY, JOHN MAYNARD KEYNES (1975) makes this clear. However, Keynes' followers, including those participating in the negotiations at Bretton Woods obviously had some faith in his ideas. See R.F. HARROD, THE LIFE OF JOHN MAYNARD KEYNES (1963).} Banks and corporations could be legislated into place. Under the tutelage of Keynes, the Bretton Woods monetary system was created by Britain and the United States for the United States and Britain. Bankers were not invited to the meetings, were dubious about the new system, and had no choice but to leave the management of the monetary system to governments.\footnote{J. ARONSON, MONEY AND POWER: BANKS AND THE WORLD MONETARY SYSTEM 38-39 (1978).} The system was designed to allow any nation to adjust its exchange rate with other currencies in response to the relative health and prosperity of its economy.\footnote{The classic work on the Bretton Woods system is R. GARDNER, STERLING DOLLAR DIPLOMACY (1956).} In fact, political restraints discouraged voluntary exchange rate adjustments. Instead, when pressures developed, capital controls were promulgated.\footnote{A. LANYI, Political Aspects of Exchange Rate Systems, in COMMUNICATION IN INTERNATIONAL POLITICS 423 (R. Merritt ed. 1967).} In the late 1950s, just as the Bretton Woods system reached its zenith, structural inconsistencies became evident.\footnote{R. TRIFFIN, GOLD AND THE DOLLAR CRISIS 35-47 (1960).} Patchwork controls were no longer effective, so exchange rate adjustments became commonplace.

Meanwhile, American constraints on capital flows stimulated the growth of the Eurodollar market, beyond the grasp of national monetary authorities. Banks and corporations supported the fixed rate Bretton Woods system which had nurtured their post-war growth.\footnote{Before final approval many U.S. bankers opposed the IMF and favored the World Bank. J. ARONSON, supra note 6, at 38.} Exchange crises were predictable. Open positions could be hedged to protect against losses. Significantly, before 1971 foreign exchange operations were service centers not profit centers for major banks. Clearly, while currencies moved only within narrow boundaries, large profits were generated only
during crises culminating in currency realignments. Although foreign exchange dealers might have earned larger profits by provoking crises, there is no evidence that this occurred in the 1950s or 1960s.\textsuperscript{11} It was senseless to disrupt a successful monetary regime to take short-term profits.

While confidence in the fixed rate system remained high, banks often took open positions to cover their customers’ hedging needs, thereby helping to stabilize exchange rates. Traders closed their positions when circumstances permitted. Frequently, banks’ speculative activities permitted central banks to remain out of the markets.\textsuperscript{12} As long as market participants believed that the United States and Great Britain would defend their currencies against devaluation, the exchange markets were largely self-regulating.

From the late 1940’s until August 1971 banks influenced the timing of crises, but rarely caused crises. When a nation’s economy weakened or strengthened, making its currency a candidate for adjustment, banks advised their corporate clients. These corporate customers then increased their leading and lagging of payments and began hedging previously uncovered transactions. These actions pressured the target currency in the forward markets.\textsuperscript{13} The banks, acting as equilibrating speculators, accepted long positions in weakening currencies (or short positions in strengthening ones). Traders immediately offset their positions in the spot markets, which forced central banks to supply them with funds. American and British banks often were unfairly labeled as malicious speculators because of these offsetting spot activities.\textsuperscript{14}

While exchange rates floated between mid-August and mid-December 1971, banks learned that exchange rate volatility could be profitable.\textsuperscript{15}


\textsuperscript{14} After the 1967 sterling devaluation the Bank of England tried to punish “speculating” banks by threatening to cancel all spot contracts not settled on time. Since the exchange markets were closed, banks which were short in spot sterling but long in forward sterling were caught. The New York banks, led by Morgan Guaranty, appealed to the New York Federal Reserve Bank for assistance. After a rapid study of the situation, the New York Fed loaned the commercial banks the sterling they needed. See, Board of Governors of the Federal Reserve System, Minutes of the Federal Open Market Committee Meeting 10-11 (Nov. 27, 1967).

\textsuperscript{15} Under fixed exchange rates it was extremely difficult to make any profits because there was less volume and little volatility. More on foreign exchange profits and bank activities can be found in J. E. Spero, The Failure of the Franklin National Bank 21-25 (1980).
Banks rediscovered the virtues of free markets. As foreign exchange volume increased, so did bank profits. Volatility of rates made wider bid-offer quotes acceptable and allowed traders to make profits without taking large, open, overnight positions. Many of the banks which entered London for the first time in the 1970s planned to cover expenses until they established their Eurodollar business by earning foreign exchange profits. The demand for traders was so great that inexperienced dealers rapidly gained substantial authority in the euphoria which accompanied foreign exchange profits.

Most American, British, and Canadian banks made their foreign exchange profits on volume and differentials. However, some continental European banks evidently took open positions, alone, or in cooperation with other banks, to manipulate exchange rates during the trading day. Such speculation when combined with the general volatility of exchange rates created short-term discrepancies between the performances of economies and currencies. Often, traders believed the dollar was undervalued, but were unwilling to act on that belief because they did not trust the efficiency of the adjustment process. Large banks speculated (i.e. took open positions) less than before, this allowed speculative actions by smaller institutions to move exchange rates without regard for the economic outlook. Volatility was caused by too little, rather than too much, speculation. Indeed, central banks have been forced to intervene in exchange markets in greater magnitude in the 1970s than in the 1960s.

Traders became uncertain of the market's medium-term economic outlook and began reacting to news flowing over the Reuters teletype. Some American banks speculated to try to recoup losses in other parts of their operations. They helped create volatility, hoping to earn profits on the swings. Eventually, the initial mania ended when losses by the Franklin National Bank, Herstatt, Lloyds' Lugano branch, and others surfaced. Short-term speculation receded for a time and some order was reintroduced into the markets. By the late 1970s, however, confidence in the dollar and in the functioning of the foreign exchange markets fell once again.

America's balance of payments remained in deficit while inflation in

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16 The author's information is gleaned from personal experience and interviews. Although economists of all stripes favored the adoption of floating rates well before 1971 only Citibank among the major American banks advocated floating rates before August 1971.
17 The author's information is based on personal experience and interviews.
18 J. Aronson, supra note 6, at 110-123.
20 Franklin National Bank was the most spectacular case. Foreign exchange dealings offered the opportunity to make quick profits to cover losses elsewhere in a bank's book.
the United States increased. Soaring energy costs, paid for on the international market almost entirely in dollars, required huge movements of funds from country to country and currency to currency. By the end of the 1970s the Eurocurrency market had grown to over a trillion dollars on a gross basis and to $600 billion on a net basis.\footnote{World Financial Markets, Dec. 1979, at 15.} Not surprisingly, some central banks, flush with dollars, chose to diversify their reserves by exchanging some dollars for stronger currencies or for gold. Many corporations and individuals also sold dollars.\footnote{Central banks from Singapore to Nigeria have diversified their reserves. Some Arab OPEC nations spent their dollar receipts for imports while holding their non-dollar receipts. Individuals also started investing beyond American borders.} Pressure on the dollar was predictable. However, Richard Cooper, the Under Secretary of State for Economic Affairs, while arguing that the exchange rate experience of the mid and late 1970s generally conformed to economic realities, recently admitted that

there were clearly several occasions, briefly in the fall of 1977 and more notably in October 1978, when exchange rates moved too far too rapidly. It is difficult to explain the developments in October 1978 in terms of the underlying economic developments.\footnote{Address by Richard Cooper, World Affairs Council of Philadelphia (Oct. 31, 1979).}

The dollar's volatility in October 1978, however, was not simply a result of bank speculation. The continuing American payments deficit and growing worries about inflation made surplus nations like Germany and Switzerland appear attractive resting places for funds. American leadership and will to triumph are in doubt. Without a restoration of confidence in America's vision, leadership, and determination to control its economy and maintain the monetary system, it is not irrational to sell dollars and buy gold or stronger currencies. Since private firms and individuals now control far more dollars than central banks, they can overwhelm the system if they panic. The dynamics of flexible exchange markets allow uneven lurches of exchange rates instead of smooth trajectories. The short-term, prudent pursuit of profits by banks and corporations could lead to a falling dollar and the collapse of monetary order, even though none of the participants favors this result.

The growing influence of the banks can be viewed in another way, by looking at the changing nature of foreign exchange crises in the past decade. Under the Bretton Woods system of fixed exchange rates, foreign exchange crises were spectacles of confrontation between central banks and the market. Central banks defended well demarcated currency perimeters against all incursions. Bank and corporate transactions put pressure on exchange rates when the market believed currencies to be under or over valued. Leads and lags of payments, not open currency positions,
provided the main pressure during exchange rate crises.\textsuperscript{24}

Crisis outcomes were a function of the relative willpower and of funds available to adversaries. Until 1965 the central banks were stronger on both counts. Governments refused to adjust their exchange rates because they feared reprisals at the polls. Government will was strong and their word was generally accepted. The United States, the key country, pledged to maintain the dollar's convertibility into gold at $35 per ounce, its value since 1934. Such steadfastness inspired confidence and stability. Corporations frequently left their foreign positions unhedged, believing exchange values would be essentially fixed when their bills were settled. Foreign exchange volume was extremely light by today's standards. In such an atmosphere, blessed with superior funds, central banks won most of their battles to maintain exchange rates.

However, by the mid-1960s banks and corporations grew more certain that the pound and dollar were overvalued and the mark and yen were undervalued. They became convinced that exchange rates were being defended for political, not economic reasons and began seeing themselves as the "conscience" of the system. Moreover, the Eurodollar market, inflated by U.S. exchange restraints and by its own convenience, swelled the liquidity available to private actors. In 1964 the central banks assembled a $3 billion swap package to salvage sterling when newly elected Prime Minister Harold Wilson was unwilling to devalue.\textsuperscript{25} The balance of economic power was shifting. The British conceded defeat, renounced their promise to defend sterling, and allowed its devaluation in November 1967.

Sterling was the dollar's shield. Since it was weaker than the dollar, the market attacked it first. Then the dollar became vulnerable. After a preliminary skirmish in May 1971, exchange market participants knew they could defeat the dollar. Nonetheless, few private executives understood the implication of the dollar's devaluation before the fact. They sought an adjustment in its exchange value, not the destruction of the Bretton Woods system. Instead, they initiated steps which led inevitably to an increase in their political influence during exchange crises.

After the Smithsonian accords, fixed rates with wider margins were restored. The most important change was perceptual. Once the dollar was shown to be vulnerable, market confidence in American willingness to prevent a recurrence vanished. Backwash crises developed in which capital markets transmitted massive short-term flows from currency to currency. Before August 1971 traders used the dollar as a resting area to await crises in other currencies. Since then, bank traders and corporate treasurers have not trusted the dollar or the U.S. authorities. They

\textsuperscript{24} P. Einzig, Leads and Lags: The Main Cause of Devaluation 136-141 (1968).

\textsuperscript{25} C. Coombs, The Arena of International Finance 121 (1976).
treated the dollar just like any other currency even though its centrality to the monetary system remained. The velocity and volume of foreign exchange transactions have grown almost without pause since the dollar was revealed as being vulnerable.

Backwash crises did not always need deep underlying roots: spurious rumors could ignite them. The June 1972 sterling float followed Britain's repayment of its outstanding IMF debt for the first time since 1964 while Britain was running a small, if diminishing, balance of payments surplus. Then Treasury Under Secretary Paul Volcker praised the strength of sterling, concluding the day before the float that surplus countries were in no position to devalue.26

The second dollar devaluation was almost entirely different from the first.27 Almost everyone inside the U.S. government believed that the first devaluation had been too small, another devaluation would surely restore the U.S. competitive balance. Actually, in mid-January 1973, only three weeks before the devaluation, the dollar was stronger than at any time since the Smithsonian accords. Italian and Swiss moves sucked the dollar into the whirlpool. Currency flight set off by these nations forced the United States to devalue on February 12, 1973. Modified fixed exchange rates were once more instated in the wake of the devaluation. Three weeks later, the market spoke. Although government and private observers agreed that the second dollar devaluation was large enough, rumors that the European nations were considering a joint float of their currencies fueled another speculative run from dollars to marks on March 1, 1973.28 The Bundesbank was smothered by an additional $3 billion in less than an hour before closing its doors.29 The European markets closed. They reopened on March 19, 1973, to a new floating exchange rate system and to a new type of crisis.

In effect, governments and central banks acknowledged that they no longer could control the markets. In 1972 and early 1973 neither banks nor central banks steered the markets. After March 1973, the governments decided to let the banks and other private actors run the game. A new type of crisis emerged, where instead of massive movements of reserves, there were huge swings in exchange rates. Unacceptable volatility forced central banks to resume limited intervention to smooth rates three months after their departure from the markets. A certain amount of bank speculation almost certainly distorted the adjustment process.

28 J. Aronson, supra note 6, at 104-05.
29 Id. at 106.
Most observers intone that without flexible exchange rates the monetary system would have collapsed completely under the onslaught of petrodollars after 1973. Perhaps this is so, but the mechanism for achieving regime change destroyed confidence and stability. It is at least as plausible to argue that the markets could not have equilibrated as well as they have without the continual intervention of central bankers "leaning into the wind." In fact, under the supposedly flexible exchange rate system, there has been more central bank intervention to manage exchange parities than there ever was before August 1971. The authorities' control is more tenuous and their strategies more secretive today, but their market patrolling has discouraged the more rampant market speculation.

Problems for the dollar, given the tremendous amount of global dollar liquidity, would continue with or without speculators. Crises today are characterized by extreme exchange rate volatility coupled with huge market intervention by central banks. The banks, along with transnational enterprises, have the ability to threaten currency parities and even the survival of the monetary system while pursuing short-term rational strategies. Their power in the system has grown and their centrality to it has become quite evident. To reestablish their dominance the United States has tried to strengthen its own economic position. The issuance of non-dollar denominated Treasury bills announced by President Carter on November 1, 1978, helped for a time. The strong actions taken by Federal Reserve Chairman Volcker on October 6, 1979, indicated a renewed determination by the Federal Reserve to support the dollar. The U.S. also began to attack its trade balance in 1979. Despite large increases in the price of oil in 1979, the U.S. balance of trade deficit declined somewhat. However, confidence in the dollar and the monetary system have been further undermined by the Iranian crisis. In panic, investors have moved into precious metals and short-term securities. Movements in gold and in the dollar are far more related to the political than to the economic success of the United States at this time.

In summary, the monetary system is suffering a structural crisis. Private institutions, governments, and individuals seeking to defend their positions are unhappy holding too many dollars. They do not trust central banks or finance ministries of the major developed nations. And, they hold sufficient dollars to undercut its exchange value at will. Crises today combine the attacks on government reserves characteristic of the pre-1971 period with the tremendous volatility of the mid-1970s. Market confidence is low; panic is not out of the question. Most observers agree that we need to rationalize if not to reform completely the monetary system, but nobody has indicated how to make the transition without suffering

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30 H. Minsky, Financial Interrelations, the Balance of Payments, and the Dollar Crisis, in Debt and the Less Developed Countries 103 (J. Aronson ed. 1979).
severe crisis or collapse first. Indeed, bankers are concerned about the security of their own financial markets and were not forlorn when the Iranian financial crisis reinjected some restraint into international lending even in the face of continued excess supplies of available dollars to loan. It is therefore important to assess the changing scope, but also the evolving limits of private actors' influence in the monetary system.

III. Bank and Insurance Influence in the Monetary System

Most academic studies of the influence of multinational enterprises have focused on the interactions between manufacturing and extractive enterprises and home and host country governments. It is logically descended from Raymond Vernon's path-breaking research on 187 U.S.-based, Fortune 500, industrial companies. Comparative work on European, Japanese, and developing country-based enterprises has begun to appear and reinforces the emphasis on corporate-government relations. Political science and policy studies on service industries have been sparse, although a growing literature on financial institutions, particularly in relation to developing countries, is emerging. Again, however, these banking studies have focused on bank-government interactions. The political importance of insurance, construction, advertising, or the legal and accounting professions has been almost totally ignored. This is so even though they are actively involved in international business.

What has not been widely realized is that service industries such as banks or insurance enterprises require a different framework of analysis than extractive or manufacturing industries. Service industries are the catalysts of the system which maintain the linkages between nations and between transnational enterprises, thus holding the international economic system together. If banks and insurance enterprises ceased operating, the trade and monetary systems would cease to function. This is so obvious that it is almost never considered. When examining the functioning of the monetary system, it is necessary to analyze the interaction of service industries with the system and within the system as well as with governments participating in the system. Banks and insurance enterprises are the links which hold the system together and allow it to function. As their roles change, so does the system and its stability. Unless this relationship is understood by those in the public and private sectors, regulations aimed at the service sector are more likely to distort the system then to manage it.

31 R. KEOHANE & J. NYE. Power and Interdependence: World Politics in Transition (1977), examines the need for regime change in the monetary system. It does not tackle the more difficult problem of finding adaptive strategies to accomplish these transformations.
A. Banks Within the Monetary System.

Banks are the intermediaries which allow for the transfer of funds from one nation to another and the exchange of one currency for another. Reacting to market forces and to their own profit seeking, they should help stabilize the monetary system. Thus banks performed with great success the complex task of recycling the petrodollar glut in the mid-1970s. Although the magnitude of funds flowing between nations shifted radically almost overnight, banks redistributed the funds among themselves and recycled them to nations which were suddenly caught short. Banks increased their balance of payments lending to stricken industrial nations and boosted their credits to wealthier non-oil exporting developing nations. Official bilateral and multilateral aid therefore could be used to assist the least developed nations. It seems evident that by redirecting the financial intermediation between surplus and deficit countries in the mid-1970s, Western commercial banks minimized the deflationary effect of the OPEC surplus and thereby made an important contribution to monetary stability. In addition, the banking system has contributed to market stability by helping stretch out the maturity structures of OPEC depositors, thereby calming fears of immediate flight of the deposits without warning.\textsuperscript{32}

However, the transformation of the international banking market has also slowly changed the role of the banks in the monetary system. Before World War I, banks and their home nations functioned together, seeking common goals. Only in Japan does this pattern still hold. Today increased international interdependence means that the largest banks, from whatever country, frequently have more in common with each other than with smaller banks from their own countries. In the early and mid-1960s the largest banks shared the international market among themselves. Competition was not too great so the good business could be spread around. Profit growth was much higher outside of their domestic markets than within. Prodded by U.S. exchange constraints in the mid-1960s, smaller regional banks moved abroad. Japanese and German banks followed later. By the early 1970s competition for international banking business was intense.

The United States government was probably more responsible for the changing role of banks in the markets and the monetary system than any other government. America’s attempt to reverse its balance of payments position through the imposition of the Interest Equalization Tax

\textsuperscript{32} R. Vernon, Sovereignty at Bay (1971) was the first major landmark in the reexamination of the role of multinational enterprise.

(1963), the Voluntary Foreign Credit Restraint Program (1965), and the
Foreign Direct Investment Program (1968) may or may not have delayed
the first devaluation. It certainly accelerated the growth and attractiveness
of the Eurodollar market and virtually forced many smaller banks to
move abroad more rapidly, more vigorously, and in greater numbers than
otherwise would have been prudent. Smaller non-American banks and
some previously insular large foreign banks were prompted to become
more international or risk declining market visibility and profits.

Each bank entering the international market needed to establish an
immediate profit base. Since most of the best traditional borrowers were
already committed to large banks, newcomers had to hustle business or admit
defeat and return home. Since the public relations costs of retreat were high, newcomers stole business from established institutions. In
the foreign exchange markets they pushed the bid-offer differentials
closer together and took open positions during the business day. In the
Eurocurrency markets, newcomers accepted slightly lower fees, pushed
margins down, tenors out, and gave borrowers the chance to take more
funds. The most credit-worthy customers discovered that they could bor-
row money on such favorable terms that banks made acceptable profits
only through undertaking huge volumes of business on minimal capital.
The large banks' oligopoly was broken and competition increased. There
was surplus liquidity in the markets, a need to lend these funds, and in-
evitably a decline in the quality of borrowers. The largest banks started
lending to developing countries, socialist nations, smaller multinationals,
and more recently to the People's Republic of China. Although the risks
were higher, so were the profits, and the competition was less. Gradually,
however, small banks ventured into these markets as well.

A borrower's market emerged. Banks which once sought borrowers
able to repay the interest and a portion of the principal of their loans out
of their expected cash flow, began accepting debtors unable even to pay
the interest on their loans from projected cash flows. Intense competi-
tion among lenders during 1973 and 1974 further eroded bank lending
standards. This deterioration was briefly constrained by the banking cri-
sis of 1974, but banks were so liquid after the OPEC price rises that
lending necessarily resumed. Problems intensified when traditional bor-
rowers' loan demand stagnated. Prime borrowers switched to the bond
markets and the commercial paper market from the Euromarkets. By

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34 J. Aronson, supra note 6, at 69-91; J. Conybeare, United States Foreign Economic
Policy and the International Capital Markets: The Case of Capital Export controls, 1963-

35 A common joke in London in the 1970s was that many small banks wished they
could be the second bank to leave. Although a few banks have now departed, 387 non-
British banks were represented in London in November 1979.

1979 over forty-three percent of Eurocurrency syndication funds went to non-OPEC developing nations.\textsuperscript{37}

Banks assured their stockholders and themselves that these new loans presented no major problems.\textsuperscript{38} They pointed out that there had been no major LDC (less developed country) defaults since World War II and that the growth of Eurocurrency loans to these nations, when adjusted for inflation, was not out of line.\textsuperscript{39} They neglected pre-World War II experiences which indicated that “productive loans to developing countries are not very productive and do not stay long out of default.”\textsuperscript{40} In part this was because banks did not have to worry about the repayment of Eurosyndicates until the late 1970s. The eight and ten year loans made in the early 1970s took their profits up front, but the principal was not due until the end of the decade. So far, loans have been rolled over or rescheduled, but rarely repaid.

In theory, the banking system should funnel funds to projects and countries where long-term economic returns will be maximized. In practice, the banking system has not realized sufficient rent for the use of its funds as the risks justify. There are two reasons for this miscalculation. First, the “over-competition” of swelling numbers of banks competing for a slower growing amount of desirable business distorted risk-return analyses. Unfortunately, there is no easy way to correct the situation. Large banks are so committed to some developing countries that they cannot withdraw. If smaller banks decide to pull out of a shaky country, the large institutions must assume their positions as well or risk country defaults. In addition, banks are not terribly worried about even major losses since most institutions involved internationally are large enough that their national governments would probably bail them out rather than risk disrupting their domestic economies.\textsuperscript{41}

A second reason for bank miscalculations was their complacency towards political risks. Bankers averred that although manufacturing and extractive firms were vulnerable to nationalization, no rational national leader would destroy his nation’s credit-worthiness by defaulting on international bank loans. While the banks accepted intermittent loan roll overs, as long as interest continued to be paid, this actually benefited them by making it unnecessary to find new borrowers.\textsuperscript{42} In the late 1970s

\textsuperscript{38} See I. Friedman, The Emerging Role of Private Banks in the Developing World (1977) and Cleveland & Brittain, Are the LDCs in Over Their Heads?, 55 Foreign Affairs 732 (1977).
\textsuperscript{39} I. Friedman and Cleveland & Brittain, supra note 38.
\textsuperscript{40} C. Kindleberger, Debt Situation of the Developing Countries in Historical Perspective (Apr. 1977) (paper for a symposium of the Export-Import Bank).
\textsuperscript{41} Bail out can be expensive. Pumping $1.5 billion into the ailing Franklin National Bank increased U.S. inflation measurably.
\textsuperscript{42} W.A. Lewis, The Evolution of the International Economic Order 65 (1978).
banks even accepted the political risks of oil companies operating in Indonesia and Malaysia because they felt secure from national upheavals. In essence, the banks believed that their bargaining position was not an obsolescing one. They were in a stable mutual hostage position with their borrowers.

In late 1979 the banks were forced to reanalyze their position by the events in Iran. Following the seizure of hostages, the Foreign Ministry announced on November 14, 1979, that Iran intended to withdraw its foreign currency reserves from U.S. banks. The same day President Carter blocked all Iranian property and interests held in the United States or by U.S.-controlled institutions abroad. Within two days Citibank, Chase Manhattan, Manufacturers Hanover, and Bankers Trust offset their Iranian loans with their Iranian deposits. Some banks which did not have sufficient deposits to cover their loans were stuck. On November 19, 1979, a Chase Manhattan-led, eleven bank, $500 million loan syndicate was declared to be in default, despite efforts by the Iranian central bank to pay monies due and over the objection of the four non-American participants. The great Iranian asset grab began.

Although lawyers will profit from these moves for years, the banks have already learned several lessons from Iran. First, political risks are greater than the banks believed. Suddenly, a plethora of bank studies on such countries as Brazil, the Philippines, and South Korea are emerging. The banks were lucky with Iran. Other countries do not hold deposits with American banks. Thus banks are concerned about Brazil's external debt in excess of $52 billion. Increased interest rates in 1978-79 cost the Brazilians billions in extra servicing payments. The banks had assumed the Brazilians would pay when required. They were so sure that many of them committed large percentages of their total capital to loans in Brazil. Yet Brazil will need over $18 billion in external funds just to stay even in 1980. Some official rescheduling may be necessary for the first time since 1964. The banks are in a bind. If the banks and the Brazilian government press the Brazilian people too hard for funds for repayment, social unrest and ultimately even revolution could occur. (The same is true of the Philippines where a great deal of the loan calculations are based on the continued rule of President Marcos or someone in his image.) Yet, widespread rescheduling by Brazil on relatively soft terms might convince many other nations that they could opt for partial default and survive in the banking system. Whether the banking and monetary system could continue to prosper is more problematic. However, the banks are fortunate that the first instance of default came in a country where they could

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43 Mobil Oil in Indonesia and Esso in Malaysia negotiated loans with international bank syndicates which forced the banks to collect from the country, not the oil company, if oil operations were nationalized unfairly.
44 Euromoney, Jan. 1980, at 64.
protect themselves from serious harm. They may now safeguard their positions in more vulnerable, dangerous nations.

A second lesson from Iran for the banks is that the Eurocurrency markets are not completely outside the grasp of national governments. The United States government froze funds held in London and Europe.5 For the first time since the collapse of the Bankhaus Herstatt in mid-1974, significant interbank conflict exists in the banking system. Americans were the leading Eurobankers of the 1970s. It is already clear that Euros syndications have slowed in early 1980. Tenors are coming down and it is unlikely that margins will not rise. It is also not clear that U.S. money center banks will automatically reestablish their market leadership when the crisis abates. However, from a global perspective, this may be a positive development. If lending has increased too rapidly, this mini-crisis may pull it back to earth before a major crash occurs and allow bankers to reassert order in the markets. Although bilateral and multilateral aid will need to increase to meet the problems generated by the 1979 petroleum price rises, the banks may end up playing a more selective, prudent role in the next round of the monetary drama. They are less likely in the early 1980s to precipitate a crisis leading to monetary collapse.

A final point underlined by the Iranian crisis is a side issue, not emphasized by the media. Iran has threatened not to accept dollars in payment for its oil in the future. Oil payments in non-dollar currencies instead of subsequent diversification of dollar-denominated oil bills may help diminish the growth of dollar liquidity in the monetary system. As long as Saudi Arabia, Kuwait and the Emirates do not follow suit, some payments for oil in currencies other than dollars will force less dollar borrowing and contribute to dollar and monetary stability. It is possible that slowing of dollar growth in the Euromarkets could make it more likely that nations will successfully negotiate a substitution account to soak up wayward dollars.

In summary, the banking system’s inertia towards over-competition was disrupting sane economic and monetary developments until the advent of the Iranian crisis. As in government bureaucracies, the banks have had trouble keeping sight of their economic goals, consequently the process took over. Previously, bankruptcy forced the losers out of the system. However, this adjustment mechanism is now too expensive to the nations involved and for the stability of the monetary system. The largest banks

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5 The Euromarkets got their initial boost when the Soviet Union, fearing that the U.S. might block their deposits in America, put their dollars in London and Paris bank accounts instead. The only precedent for offshore freezing of bank deposits is United States v. First National City Bank, a 1965 case in which the Supreme Court froze deposits of a Citibank client in Uruguay. In that case, no foreign laws were violated.
in each nation are sacrosanct. Their demise would upset national and international economic systems. Although the system is largely out of control and self-correction is extremely difficult, the potential for disaster remains largely unrecognized. We are not asking the right questions. It is necessary to begin to understand the role of banks in the evolution of monetary regimes. In a financially interdependent world it is too expensive to pass hegemonic leadership from one leader to another only after system collapse. System self-adjustment, which requires knowledge of the role of service sector corporations, is necessary. Further research on these factors is needed.

B. Insurance Within the Monetary System.

Insurance and insurance enterprises have been almost entirely ignored within the broad context of global economic and monetary affairs. The implications of cross national investment of insurance premiums, the impact of insurance on balance of payments accounts, and the linkages between insurance and inflation have been almost completely neglected. There is, however, a growing literature on the role of insurance in the process of development and a series of pieces extolling the positive benefits of free trade in insurance. In addition, there is a proliferating body of materials on public and private political risk insurance schemes. Two major stumbling blocks prevented serious consideration of the macro-economic and political effects of insurance. First, insurance regulation, particularly in the United States, is decentralized. Each state has its own rules and usable aggregate statistics are rare. Outside the United States, regulatory differences abound and again statistics are difficult to assemble. Second, the insurance market is more complex than the commercial banking system. The market consists of life insurance and general insurance companies. Insurance brokers are active and important. The reinsurance companies are crucial. Lloyd's of London, an insurance market not a company, has its own role. A New York insurance market is being organized. Captive insurance companies, owned by industrial concerns, began as self-insurers, but now accept outside business. Mutual insurance agreements such as the Protecting and Indemnity Clubs in marine lines also abound. And, of course, insurance is divided by lines (e.g. marines, fire, life, aviation) each of which plays its own special role.

See G. Junne, The Impact of Transnational Insurance Corporations on Developing Countries, U.N. Centre on Transnational Corporations, (March 1977), and numerous reports prepared by the Committee on Invisibles of the United Nations Conference on Trade and Development. See also L. Buol, UNCTAD's Special Program in Insurance, Best's Review, Nov. 1975, at 56-59. The leading advocate of free trade in insurance has been the American International Group.

Yet there remain important reasons to begin the research effort. Insurance is a vast, and increasingly international industry. Global 1977 premiums were estimated at just under $300 billion, almost half originating in the United States. The most active insurance purchasers are in the United States and the United Kingdom where, in 1977, premiums as a percentage of gross national product were 7.67 percent and 5.67 percent respectively. Moreover, insurance premiums are expanding faster than the gross national product worldwide. The ratio of insurance premiums to world GNP (excluding the Eastern Bloc) increased from 4.75 percent in 1967, to 5.15 percent in 1972, and to 5.34 percent in 1977. Moreover, domestic insurers, worried by the saturation of their home markets and the growing competition for solid, domestic business, have moved abroad to find new profit opportunities and to spread their risks. The flows of these insurance and reinsurance premiums and payments across national boundaries and the investment decisions of transnational insurance enterprises may have important consequences for international monetary operations. One recent article, for instance, estimates that in 1977 the U.S. experienced a $3 billion insurance deficit and that between 1958 and 1977 the U.S. deficit on freight and insurance (on merchandise plus non-merchandise insurance free on board) totaled almost $14 billion. At present, however, nobody knows for sure: the data is lacking. However, it is possible to speculate on potential effects of insurance operations on monetary stability.

In theory, insurers accept risk and instability from those they insure, allowing the insured to plan their cash flows more efficiently. Ironically, insurers are unable to manage their own stability of income and returns. Insurance companies therefore expect that each line of the business will show returns which over time roughly approximate a sine wave, the so-called underwriting cycle. If the insurance market works efficiently, when profits are too high new underwriters will enter the market, forcing down the rates. When profits inevitably dip, speculators will flee the market in search of higher returns on their funds. In the process, insurers will “rate” risks, differentiating between those they insure on the basis of safety of operation, efficiency of management, and past record. The better the record the lower the premium rate and vice versa.

In practice, the stability of underwriting cycles is now widely questioned. Underwriters are writing business for premium income. Their profits come from investment of the premiums not from underwriting.

48 SIGMA (a publication of Swiss Reinsurance Co.), May 1979, at 6, 10.
profits (i.e. the difference between premiums paid in and claims paid out). There has been so much new additional underwriting capacity in most insurance lines that underwriting profits have largely vanished and investment profits predominate. Indeed, many insurance enterprises show consistent underwriting losses.\textsuperscript{50}

While investment returns remain high, and the world economy expands, the insurers are satisfied. There has been no slowdown in the rush of new faces to the insurance markets, even if the effective rating of most risks is now impossible. Some insurers wish for another Hurricane Betsy to restore order. And, they insist, only a major catastrophe will help: aviation disasters and major oil spills hardly budge the rates or slow the growth in insurance capacity.\textsuperscript{51}

Some critics argue that insurers, in their greed for premium income, have insured “uninsurable” projects. It is also not clear that the conventional assumption that “the greater the catastrophe the less likely its occurrence” is valid.\textsuperscript{52} Difficulties are obvious in the rash of misjudgments, frauds, and disasters that have recently shaken Lloyd’s of London.\textsuperscript{53} Should greater losses occur, the capital of many insurance enterprises could be severely tested. Without insurance coverage the continued expansion and interdependence of the world economy would be threatened. Since insurance is now so international, the consequences of collapse would also be international in scope. Yet if national governments try to control insurance flows overtly, without understanding the system they are trying to regulate, they risk crimping their own economic growth.

\textbf{C. Banking, Insurance and Possible Monetary Instability.}

In conclusion, banks and insurance enterprises are so central to the operations of the economic system that serious problems within the financial system could threaten the continuing adjustment of the monetary and trade systems. Moreover, both banking and insurance have become more international and more fragile in the past fifteen years. Banks’ international lending increased faster than the growth of sound borrowers in the system. Insurance capacity rose faster than insurable risks. The quality of business for both industries has declined. Although there are now some signs of a slow reversal, the borrowers and the insured have

\textsuperscript{50} B. Doody, A Detailed Analysis of Results 1950-1977 (1979).
\textsuperscript{51} The author’s information is gleaned from personal experience and interviews.
\textsuperscript{53} Lloyd’s of London was racked with major losses and scandals in the late 1970s. Huge losses were suffered when Lloyd’s unwisely ventured into insurance for computer leasing. The Frederick Sasse syndicate was bankrupted by giant losses, particularly in the American fire market. Fraud may be involved in the Savonita Affair losses in which Fiats were “destroyed” during a fire but were then resold at a substantial portion of their original price after full insurance compensation was made. A new scandal surrounding the scuttling of ships is brewing. See FAR EASTERN ECONOMIC REVIEW, Nov. 16, 1979, at 66.
been able to extract extremely favorable terms from the banks and insurers. A borrower's market prevailed in banking with spreads dropping sharply throughout the late 1970s. Insurers slashed premiums, fully aware that price cutting would erode underwriting profits. Insurance brokers used the existence of surplus insurance capacity to hold rates stable for risk-prone customers and to win reductions for better risks. The frequency, amplitude, and predictability of insurance underwriting cycles across most lines broke down.

Eventually, unrealistic pricing in banking and insurance will vanish, but the transition could prove costly to a variety of economies and to the economic system as a whole. Developing country reschedulings of their bank debt are now an accepted part of international finance. If banks fail to roll over debts from major countries or if the countries refuse to meet their obligations, the banking and eventually the monetary system could be shaken. Similarly, earthquakes in California or Japan, a series of big storms, or even the destruction of a multi-billion dollar liquefied natural gas facility could topple major insurance actors, disrupt the insurance system, and paralyze the transfer of goods and services among nations. Unless the banking and insurance systems, these crucial service industries, function with relative smoothness and efficiency, the economic fabric of global interdependence could begin to fray. Unfortunately, there does not seem any great hope that the systems will demonstrate renewed self-correction or that governments will enact regulations to effectively direct banks and insurers to pursue system constructive paths. Unless there is some movement towards strategic goal setting and greater concentration of the process of getting to those goals, tragedy and collapse are not impossible.

IV. THE NEW SERVICE CONGLOMERATES AND MONETARY STABILITY

Potentially destabilizing competition is not, however, limited to the banking and insurance markets. Manufacturing and extractive industries are evolving into more service oriented institutions. They are earning increasing percentages of their revenues from fee income and other service activities. They are diversifying into and acquiring service oriented profit centers. Their product lines are far less distinct than they were a decade ago. Industrial enterprises are already competing in many areas with traditional service companies. Very shortly governments may find their regulation of these companies and of the economic and monetary systems still more difficult. Apparently, the impact of industrial firms on the structure and functioning of monetary, trade, and investment relations among nations will continue increasing. Growing global service industry interdependence will make regulation of the economic regimes even more
complex. Government regulations aimed at controlling corporations instead of at directing the evolution of the economic system will prove futile and ultimately destabilizing. Some form of international regulation will be required to prevent the unstable forces of “over-competition” within the market from wreaking havoc with economic order.\footnote{Economists become extremely agitated when non-economists write of “over-competition.” But Minsky’s work on financial fragility and C. Kindleberger, \textit{Manias, Panics, and Crashes: A History of Financial Crises} (1978) strongly suggests that such a state is not only possible, but fairly common. In short, financial markets are not self-equilibrating and are never likely to be.}

Two key factors have provoked the evolution towards service conglomerates. The change from fixed to flexible exchange rates exposed large international corporations to substantial, unpredictable exchange and translation risks previously absent. Corporate executives were forced to worry about the danger of “yo-yo” profits influenced by exchange crises which could disrupt the smooth growth of product generated profits.\footnote{See S.M. Robbins & R. Stobaugh, \textit{Money in the Multinational Enterprise} 161 (1973).} While fixed rates prevailed, corporations focused on their product lines and let their banks worry about exchange markets. Flexible exchange rates demanded more extensive hedging strategies which in turn required hiring new financial experts. The oil companies, IBMs, and ITTs now maintain full trading desks comparable to those in major banks. Once financial experts flocked to corporations, they began to turn the treasury departments into profit centers. Large industrial enterprises began bypassing the commercial banks when they needed to buy or place funds. This boosted the commercial paper market, saved money for the corporations, hurt bank profits, and forced banks to seek new profit opportunities of their own. Most corporations also established Bermuda-based captive insurance companies, many of which started writing insurance for other companies.\footnote{It is reported that an executive of one major U.S. steel firm, when asked why his company was putting so much capital into its insurance captive, responded, “We think it is a better use of our funds than putting them into steel.”}

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A second push towards service and fee business was caused by the growing fear of political risks. Most analysts agree that extractive, resource, and mature manufacturing companies are more vulnerable to foreign political pressures for nationalization or contract renegotiation than are service industries or companies with sophisticated technologies and
high research and development components. IBM feels more secure than United Brands. As a result vulnerable corporations have sought ways to split their risks or to manage them. Joint ventures, management contracts, consulting and licensing agreements, front end fees, and numerous other strategies contributed to safe, proliferating fee income. The ultimate example of this kind of transformation may be ARAMCO, a firm which no longer owns any oil. Nonetheless, they continue to make record profits in management fees, transportation costs, and marketing advice needed by Saudi Arabia.

These developments suggest that the management of the international monetary and economic realm is growing more complex and more important. The prospects for smooth transition to a new, workable monetary system, for instance, is less likely than a rough transition following severe crisis or even worldwide collapse. However, the pressure of competition within the private sector is still growing, no plateau is in sight. Pressed by competition from previously non-financial firms, banks and insurance enterprises have sought new profit sources, here and abroad. Banks now compete directly with Savings and Loans and with insurance companies. Insurance companies are moving into the banks' traditional markets. The Glass-Steagall Act is more legal fiction than fact in the United States and internationally. At home, national banking is almost reality. Abroad, commercial banks are competing as investment banks. Everybody is encroaching on other industries' markets, creating huge service conglomerates that are difficult to regulate and unlikely to improve the efficiency of market competition.

V. CONCLUSION

In summary, banks, insurance enterprises, and other service sector companies can directly affect the operations of the international economic system and its various subsystems. The instability in the monetary system, in particular, has allowed for a growth of bank, and perhaps, insurance influence on the structure and functioning of that system. However, regulators still focus on the need to control corporations operating from or within their borders. In pursuing domestic goals, they are likely to distort the international workings of the system, doing more harm than good. Unfortunately, the market does not seem to function smoothly at a global level. Over-competition and eventual crisis and collapse have been the historic rule. Banking and insurance are presently coming out of a severe price-cutting debacle with potential long-term destabilizing effects.

The most cited example of differences in political risk sharing strategies leading to vastly different results is the case of Anaconda and Kennecott copper companies in Chile. See T. Moran, Multinational Corporations and the Politics of Dependence: Copper in Chile (1974).
Other firms which previously operated within the international system are becoming a part of the functioning of the system as more and more of their revenues are service based. Unless private executives and government officials start examining the problems of money, trade, and investment on a geo-economic level, collapse is more likely than an *ad hoc* transition.