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Fall

1986

Federal Reserve Bank of San Francisco

Economic Review

Number

4

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The Federal Reserve Bank of San Francisco's Economic Review is published quarterly by the Bank's Research and Public Information Department under the supervision of John L. Scadding, Senior Vice President and Director of Research. The publication is edited by Gregory J. Tong, with the assistance of Karen Rusk (editorial) and William Rosenthal (graphics).

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International Financial Crises, Past and Present

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Prior to the international financial crisis in 1931, the principal barrier hindering adjustment by the international financial system to macroeconomic shocks was the fixed exchange rate system under the gold exchange standard. The lack of international liquidity support also contributed to the fragility of the international financial system. In contrast, flexible exchange rates since 1973 and the international liquidity support that has developed since 1982 have helped avert an international financial crisis in the present, even though underlying problems remain unresolved.

In recent years, as less-developed countries encountered increasing difficulties in servicing their debts to international banks, serious questions have arisen on the stability of the international financial system. In 1983 and 1984, at the peak of such concerns, fears of widespread debt defaults conjured up the specter of the disaster of 1931, when a rapidly spreading international banking panic brought down the international financial system, created havoc in the world economy, and lengthened the duration and exacerbated the severity of the Great Depression. In the last two years, the international-debt situation has improved considerably and fears of an imminent cataclysm have subsided. The underlying international debt problem, however, is not resolved.

In the present calmer environment, it is useful to compare the 1931 experience with the developments since 1982 for insight into underlying conditions and policy responses. The comparison sheds light on the workings of the international financial system, the conditions under which it might break down and plunge into crisis, as well as the policies that might be helpful for averting or arresting crises.

This comparative historical study cannot cover the gamut of issues on the conditions and policies for ensuring international financial stability. Instead, it will focus on two subjects: cooperation for ensuring ample liquidity during times of international *financial* stress, and the role of exchange rate flexibility in the international transmission of *economic* stresses.

The article concludes that the lack of an international mechanism for providing liquidity support prior to 1931 left the international financial system virtually defenseless against systematic, pervasive world economic stresses. In addition, the gold exchange standard then prevailing significantly contributed to the international transmission of mone-

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tary deflation and other economic stresses, gave impetus to destabilizing speculative capital flows, and severely constrained the ability of monetary authorities to support the financial institutions in their own countries during times of stress.

In contrast, the flexible exchange rate system since 1973 has released the major industrial nations from the constraints of the gold standard and helped them adjust to the series of large and pervasive shocks to the world economy in the 1970s and early 1980s. Moreover, since 1982, an international mechanism has been developed to provide the essential international liquidity support for containing international financial crises.

I. The 1931 Crisis

The financial crisis that swept over Europe from May to September 1931 and subsequently engulfed the whole world was unprecedented in its severity, scope, and speed with which it spread.

Calm Before the Crisis

As late as spring 1931, the international financial system appeared remarkably stable, despite the spectacular stock market crash in October 1929 and the onset of the worldwide Depression. With declining world agricultural prices, economic depression had begun in some far-flung countries and regions, such as Australia and the Dutch East Indies in late 1927, and had then spread to Brazil and Finland in 1928, Argentina and Canada in the first half of 1929, and to the United States and most of the European countries by the second half of 1929.[1] Times were hard and businesses were failing, but confidence in the soundness of the international financial system was not weakened.

There appeared to be some grounds for continued confidence. The outlying countries that first sustained large declines in export proceeds were able to counteract the resultant balance-of-payments strains through a combination of currency depreciation and domestic deflation. Few resorted to exchange controls.[2] None — except the Soviet Union, Mexico, Ecuador, and some local governments of Argentina, Brazil, and of the United States — had defaulted on their foreign bond issues.[3] International capital flows remained largely unrestricted as an active interbank deposit network provided international liquidity to national banking systems bound together on a gold exchange standard. For market participants reared on a belief in the efficacy of the gold standard adjustment mechanism, the unfolding worldwide depression was merely following the same course as had ordinary slumps of past business cycles.[4]

The surface calm, however, belied the increasing fragility of the financial structure underneath. As had the economic depression, the financial structure started to crumble first in the peripheral countries. From 1925 to 1930, bank demand deposits fell 27 percent in Australia, 16 percent in South Africa, 14 percent in Japan, 32 percent in Bolivia, 40 percent in Chile, and 25 percent in Peru.[5] In contrast, demand deposits either increased or were unchanged in virtually all the industrial countries in 1930, even while they were engulfed by the Depression. A 1934 League of Nations' study attributed this anomaly to banks' efforts to keep strapped borrowers afloat by rolling over old loans and extending new credits; the banks expected business conditions to improve in the near future. In the process, bad loans piled up and seriously reduced the solvency of these banks.[6]

The stress on banking surfaced in 1930. But only in the United States, with its unique system of an extraordinarily large number of independent banks (about 25,500 in 1929), were there widespread bank failures. Nevertheless, even in the U.S., banking conditions appeared to be quite stable until October 1930, as the total deposits of failed banks up to then were not significantly larger than during the preceding decade. In the next three months, however, a rash of bank failures, starting from the Midwest, climaxed in the failure of the $200 million Bank of United States in December. The panic, however, was shortlived and faded completely when the new year arrived.[7] Moreover, it seemed only to be a domestic financial stress with no noticeable impact on banks abroad.

In the meantime, banking conditions in Europe

began to deteriorate quickly. Central banks managed to keep the worsening situation from public view by conducting secret rescue operations of insolvent banks through acquisitions by financially stronger banks backed by large central bank subsidies.[8] The undercover operations succeeded in containing imminent banking crises — but not for long.

Spread of the Crisis

The deceptive calm ended abruptly with a massive run on the Credit Anstalt, the largest bank in Austria, in May 1931.[9] The collapse of Credit Anstalt was preceded by more than eighteen months of worsening business conditions and mounting loan losses in Austria. By the end of 1930, the net worth of Credit Anstalt neared zero without the public's knowledge. Ironically, it was the bank's publication of an international rescue plan to write off its loan losses and to replenish its capital that set off a run that quickly spread to other Austrian banks.

The central banks of major industrial countries — Britain, France, and the United States — did see in this situation a potential threat to the stability of the international financial system, but they underestimated its seriousness. It took them three weeks of acrimonious negotiations to come up with a paltry $14 million credit to the Austrian National Bank that was used up in five days. Negotiations for a second $14 million bogged down over the French government's insistence that Austria must agree to abandon a proposed customs union with Germany. After two weeks of frustration, the Bank of England unilaterally extended the credit, but it was too late to save Credit Anstalt. Bank runs and capital flights quickly spread to Hungary, Czechoslovakia, Romania, and Poland, which had special ties with banks in Austria.

In June, the panic hit Germany. The Reichsbank, the nation's central bank, lost nearly one-third of its gold and foreign exchange reserves in the first twelve days of June. When asked for help, the central banks responded with greater alacrity. In five days, a $100 million package was put together, with the central banks of Britain, France, and the United States and the Bank for International Settlements (BIS) sharing equally. Again, the magnitude of the needed assistance was underestimated as the funds lasted less than a week.

The rest of this story almost exactly duplicates that of the Austrian episode. The Reichsbank asked for more credits; negotiations again went nowhere as the United States refused to take part if France would not share the burden, while France insisted on scrapping the customs union proposal and also demanded that full war reparation payments resume at the end of one year of moratorium; Britain, for its part, wanted to tie the granting of credit to a final resolution of the entire war debt and reparation issue that had vexed the major countries since the end of the war. In the end, nothing was resolved.

In mid-July, the closure of the nation's third largest bank, the Darmstaedter and National Bank (the Danat Bank), triggered a full-scale run on German banks. When the central bank's gold and foreign exchange reserves were nearly exhausted, Germany proclaimed a two-day bank holiday, and then imposed exchange controls that effectively sealed off the nation from the rest of the international financial system.

In mid-July, the panic spread to Britain. On the day of the Danat Bank failure in Germany, the Committee of Finance and Industry in Britain issued its report (the Macmillan Report) revealing that London's short-term claims on foreigners at the end of March had amounted to less than 40 percent of its corresponding liabilities. The fear aroused was further aggravated by large fund withdrawals by banks in Belgium, the Netherlands, Sweden, and Switzerland, which were caught in a liquidity squeeze by Germany's exchange controls. In the two weeks ending on July 29, the Bank of England lost $200 million in gold and dollars, or one-quarter of its international reserves.

Again, foreign central banks came to the rescue. Interestingly, as the banking crisis spread from Austria to Germany and then to Britain, the size of the major central banks' joint rescue package expanded rapidly: from $14 million for Austria to $100 million for Germany, and then to $250 million for Britain. The last-mentioned, announced on August 1, was shared equally by the Bank of France and the Federal Reserve Bank of New York. Again, the size proved inadequate. On Saturday, September 19, the Bank of England's remaining gold and

foreign exchange reserves exceeded its total obligations under forward exchange contracts and borrowings from foreign banks by only £5 million. The next Monday, England went off the gold standard, suspending indefinitely the Bank of England's obligation to convert sterling into gold.

The shock of sterling's downfall was felt all over the world. Unable to use their funds in London to sustain the gold convertibility of their currencies, some thirty-three countries in rapid succession left gold within a year. Only France, Germany, the United States, and South Africa remained on the gold standard. In the meantime, 27 countries imposed exchange controls, and virtually all countries raised import tariffs or imposed import quotas.[10] Annual international debt defaults rose from near zero in 1930 to $520 million in 1931 and $830 million in 1932.[11] International lending virtually ceased. Total world trade in 1933 fell to only 35 percent of its average level in 1928-29.[12] With remarkable speed, the international economy disintegrated along with the collapse of the international financial system.

Analysis

Although much has been written on the origin of the Great Depression, there has been surprisingly little systematic study on the *causes* of the financial collapse of 1931 and on the *policy actions* that were taken or not taken for dealing with the crisis. Such a study is beyond the scope of this paper, but some comments on each of these two aspects might nevertheless be useful.

Unquestionably, a major reason for the 1931 international financial crisis was the gradual but steady spread of the recession that began in outlying countries in late 1927. The prolonged and worldwide scope of the recession severely eroded banks' asset and capital positions, an erosion that could not have been avoided by any degree of banking prudence and asset diversification. Although the fragility of the international financial system should have been evident, there is little indication that either the banking community or national authorities fully understood the situation.[13]

While deteriorating economic conditions weakened financial soundness, the resulting shrinkage in finance in turn exacerbated the economic decline. In the 1920s, long-term international lending took place largely through the national foreign bond markets, of which the American market was by far the most important. Among the borrowers, Germany was the largest, and the next five in declining order were Australia, Canada, Argentina, Japan, and India.[14] As recession spread throughout the world, foreign issues in the United States fell from $2.1 billion in the first half of 1928 to $900 million in the second half and only $450 million in the second half of 1929.[15] This abrupt decline is generally attributed to the concurrent U.S. stock market boom, which not only reduced U.S. capital outflow but also attracted large volumes of foreign capital inflow into the United States, turning the U.S. into a net importer of long-term capital by 1931. However, the deteriorating economic conditions in outlying countries, and their advance inward to the core industrial countries, undoubtedly also contributed to the sharp decline in long-term international lending.

The experience of economic contraction arising from a compounding of export decline and the international liquidity squeeze was common among many countries prior to 1931. These countries included Argentina, Australia, Brazil, Bolivia, Chile, Venezuela, Spain, and the Eastern European countries.

Australia's experience is illustrative.[16] That country had relied heavily on overdrafts at London banks to finance its foreign trade. It floated long-term bond issues to refinance short-term debts when the sums became large. In 1927, as its export prices declined, it began to pile up external debts and to feel the limits of international funding. In January 1929, an Australian issue in London was subscribed to the extent of only 16 percent. Monetary deflation in Australia then set in. By November, unemployment rose to 13 percent, and sterling had to be rationed to Australian Banks. The Australian currency began to depreciate as a market developed outside the trading banks. By March 1931, Australia's currency had fallen by 30 percent against the sterling and thus shifted the burden of adjustment to its export-competing countries.

A major cause of the gradual deterioration of the world economy in the second half of the 1920s was probably the malfunctioning of the fixed exchange

rate system and its associated international transmission of economic shocks and constraints on national macroeconomic policies. In the first place, after World War I, most nations returned to the gold standard at pre-war parities despite the high inflation that had intervened. Underpricing gold limited the supply of gold for monetary purposes, with the result of a general deflationary pall on the world economy.

Misalignment of currency created additional strains on the international economy. The overvaluation of the sterling after 1925 combined with the undervaluation of the French franc after 1926 gave rise to a large volume of speculative international capital flows that made domestic monetary management much more difficult. While payment-deficit countries, such as Britain, had to adopt restrictive monetary policies to protect their external positions, payment-surplus countries, such as France and the United States, were reluctant to pursue expansionary monetary policies for fear of inflation.

The universal deflationary bias was probably a major reason for slackening world aggregate demand. The decline in demand first hit the primary producing countries — with low elasticities both of demand and supply of their exports — and spread in time to the industrial countries.

Concern over the adequacy of gold reserves acted as a serious constraint on national authorities' choice of appropriate policies for domestic macroeconomic stabilization. Following the sterling's collapse in September 1931, there were heavy withdrawals of gold from the United States as foreign central banks attempted to use the gold reserve to defend their national currencies against speculative capital outflows. To check the gold loss, the Federal Reserve raised its discount rate from 1.5 percent to 3.5 percent in the two weeks ended October 16, 1931, and let banks' nonbrorrowed reserves fall from $2.1 billion in early September to $1.3 billion to the end of the year. From August 1931 to January 1932, the U.S. money stock fell at an unprecedented annual rate of 31 percent.[17]

In contrast, freed from obligations of defending fixed exchange rates after Britain went off gold in September 1931, the Bank of England was able to reverse its previous deflationary monetary policy. In six steps over four months, it reduced its discount rate from 6 percent in February 1932 to 2 percent. Bank deposits responded by reversing a prolonged decline, and rose from £1.6 billion in February to £2.0 billion at the end of the year. Stimulated by interest rates declines — the Treasury bill rate falling from 4.94 percent in January to 0.55 percent in September — housing construction began rising in autumn and reached a level in 1933 that was 70 percent above the level two years earlier.[18]

Finally, the collapse of the international financial system in 1931 also can be attributed to the inept international actions to contain the spread of the crisis after its start. The world community was ill-prepared for the task. The only public international financial agency that existed in 1931 was the BIS, which was established only the year before to facilitate the transfer of war reparations and to promote international financial cooperation. With $100 million of capital, of which only $21 million was paid up at the end of 1931, it lacked resources of its own for coping with the crisis.[19]

As described earlier, the major central banks' joint actions to assist distressed national banking systems were indecisive, distracted by extraneous political motives, and were too little too late. Throughout the developing crisis, the heads of the central banks of Britain, France, Germany, and the United States kept in direct touch with one another through letters, telephone calls, cables, and occasional meetings. Nevertheless, they lacked adequate information on the extent of international indebtedness[20] as well as the expertise to deal with it. In addition, there was neither an explicit mandate from their respective governments nor a sense of international solidarity that would have spurred them to effective joint actions.

The international commercial banking community was equally ill-prepared for the crisis. Their stakes were high,[21] and their vast financial resources would have been essential for supplementing the limited means at central banks' disposal to stop the spreading panic. Yet, they dragged their feet in negotiating standstill agreements in the Austrian and German crises, and joined the international rescue operations for Britain only when it was too late.[22]

In 1931, there was some recognition that without

forceful adjustments in domestic economic policies, external credits alone would not be able to ward off speculative attacks on banks. The subject, however, was not broached with the Austrian Government. Negotiations for rescuing the German banks also focused only on securing financial assistance. Only in the British case was the need for economic policy adjustment made an explicit condition for obtaining credits from foreign commercial banks. Throughout August 1931, negotiations for foreign bank loans were thwarted by the foreign banks' insistence that the British government adopt a budgetary reform program for reducing its large budget deficit, and by the Labor government's refusal to cut relief payments to the unemployed at a time of severe recession. Only after a new Conservative-Liberal coalition government agreed to accept a budget cut was a foreign bank loan assured. Throughout the negotiations, there was widespread and bitter resentment by the public toward the pressure exerted by foreign bankers on British domestic economic policies.[23]

In view of the foregoing review of the macroeconomic causes of the 1931 crisis, it is doubtful that domestic policy adjustments and international financial assistance could have held the international financial system together. The fundamental problem was an international monetary order characterized by fixed exchange rates with little international policy coordination, that permitted unobstructed international transmission of economic shocks while severely constraining national macroeconomic policy choices.

Gradually, but steadily, world aggregate demand slackened and international long-term financing dwindled amid swelling international speculative capital flows. National policymakers, strapped to the gold standard, were powerless against these increasingly corrosive forces. Eventually, the world economy disintegrated, crumbling the foundation of the world financial system.

II. Experience Since 1982

The world economy seemed to slide toward another major international financial crisis in 1982. Most of the elements were there for the making of another crisis like that of 1931, and there appeared to be several striking similarities.

Similarities

The world economy suffered a severe and prolonged recession in 1980-82. Moreover, the start of the recession almost coincided with a change in the direction of monetary policy in several major industrial countries. The new policy aimed at controlling a world inflation that had raged with varying intensity in different parts of the world over the previous fifteen years. The anti-inflationary bias in these major industrial countries recalled the same policy bias that preceded and prevailed during the Great Depression. The result was unprecedentedly high real interest rates in world financial markets.

The double shock of high real interest rates and a severe, prolonged worldwide recession drastically changed the world economic environment and simultaneously eroded the debt-servicing capacity of a large number of debtor nations. As a result, individual investment risks became systematic risks for those banks that had vigorously pursued international lending as a strategy to diversify their portfolios and enhance profits. The scope of the adverse impact on international banking portfolios was reminiscent to many observers of the precarious situation faced by international banks prior to the 1931 crisis.

Also recalling the 1931 crisis was the apparent complacency with which nations regarded deteriorating economic conditions. The U.S. recession in 1980 was generally expected to be a short one — lasting perhaps one year, which was the average duration of business cycle downturns in the United States since 1945. Under this expectation, both lenders and debtors believed that the proper strategy would be to keep lending and borrowing because a world economic recovery was "just around the corner." Given optimistic expectations, lenders let the quality of their assets deteriorate, while debtor nations felt no pressure to make adjustments in economic policies that had produced large budget deficits, inflation, and over-valued currencies. In a replay of the scenario prior to 1931, it was business as usual under the common illusion that a world economic recovery would restore the debtor nations' ability to repay their debts.

The illusion was shattered abruptly in September

1982, when Mexico announced that it was no longer able to service its $86 billion external debt and needed relief from its foreign creditors. The announcement sent shock waves through the international banking system.

The world had not been aware of the high concentration of international debt in certain debtors and lenders. At the end of 1982, nearly half of the $700 billion total external debt of the less-developed countries (LDCs) was owed by eight debtor nations: Brazil, Mexico, Argentina, Korea, Venezuela, Indonesia, Chile, and the Philippines. The debt's concentration in U.S. banks' portfolios was even higher, as the same eight debtor nations accounted for seventy percent of U.S. banks' claims on the LDCs. Among U.S. banks, the nine largest accounted for one-half of the total U.S. bank lending to the LDCs at the end of 1982.[24] The fear soon became widespread that debt defaults or moratoria by only two or three of the large debtor nations could seriously damage the capital positions of the world's largest banks, in general, and those in the United States, in particular.

The 1982 Mexican debt shock was followed by a precipitous decline in international lending. From $27 billion in the first half of 1982, net international bank lending to the LDCs declined to $12 billion in the second half of that year and only $9.0 billion during the full year of 1983.[25] This sharp decline recalled the international liquidity squeeze suffered by debtor nations prior to the 1931 catastrophe, and raised the fear that it would again precipitate widespread debt defaults.

Signs of financial fragility quickly grew widespread. From an average of one a year in the late 1970s, the number of less-developed countries' bank-debt rescheduling rose to four in 1982, fourteen in 1983, and twenty in 1984; the total amount of rescheduled bank debt increased from an annual average of $0.9 billion in the late 1970s to $1.7 billion in 1982, $41 billion in 1983, and $113 billion in 1984.[26] Separately, bank failures in the United States rose from an annual average of 8 between 1977 and 1979 to 42 in 1982, 48 in 1983, and 79 in 1984. The total assets of failed banks rose from an annual average of $453 million in 1977-79 to $11.6 billion in 1982. They dropped to $7.0 billion in 1983 and $3.3 billion in 1984, but were still high by historical standards.[27]

Fundamental Differences

The collapse to which these similarities pointed has not materialized. Despite widespread anxiety over its stability, the international financial system has continued to function well four years after the Mexican shock. Debts have been rescheduled many times, but there have been no major defaults. There have been many bank failures, but none attributable to international lending as a primary cause. The numerous manifestations of financial stress, instead of growing and culminating in a crisis, have markedly lessened in recent years.

The perceived parallel between the experience of 1982 and that of 1931, even if to some extent valid, has been misleading. The international financial system and the world economy had changed in three fundamental ways since the early 1930s: industrial nations now operate under a flexible exchange rate regime; they have a mechanism for international cooperation to cope with developing crises; and they have better safeguards to ensure the stability of their banking systems.

Flexible Exchange Rates

Perhaps the most important difference between the two eras has been the international monetary setting. No longer are the world's currencies pegged to gold at fixed exchange rates as they were before 1931. The floating of exchange rates in February 1973 came none too soon as, within a year, the world experienced its first oil shock and widely divergent resulting impacts on the real income and external-payment positions of different nations.

The floating exchange rates did not insulate the oil-import nations from the shock, but they did provide them with a mechanism to adjust to the drastically altered relative-price conditions in ways that accorded with their own national aggregate demand and supply conditions. Had the nations attempted to maintain arbitrarily pegged exchange rates, many payment-deficit nations would have had to pursue deflationary macroeconomic policies to keep their currencies in line. The 1974-75 world recession would then have been much more severe and prolonged. This same analysis can be applied to the second oil shock which took place in the 1979-80 period.

Flexible exchange rates cannot completely insu-

late nations from the impacts of oil price increases. Those developing nations that were unwilling or unable to make the needed adjustments to the price increases and continued to rely on foreign borrowings to sustain their domestic spending saw their external debts rise rapidly and at higher real interest rates. In contrast, the industrial nations underwent severe recessions in the period 1974-75 and again in the period 1980-82 to contain domestic inflation and to adjust to the higher oil prices.

By the time of the Mexican debt shock, the industrial nations had about completed their adjustments and were ready to begin recovery from the 1980-82 recession. Although reducing inflation remained a primary policy objective, they also aimed macroeconomics policies at restoring stable output growth. In none of these countries was there a deflationary bias for the sake of fixed exchange rates, as there was before 1931.

Thus, a generally strong world economy provided a sound base for international banks to cope with sectoral shocks. The LDC-debt problem was a sectoral shock to international banks, just as difficulties in agriculture, construction and energy industries were sectoral shocks for domestic banks. To a varying extent, many international banks have undergone, and are still undergoing, severe stress according to the degree of their asset concentration in LDC, energy, real estate and farm loans.

However, there is an important distinction between individual bank stress and systemwide stress. Individual banks with a large proportion of their assets in problem loan areas see their capital positions seriously eroded. But because the core countries in the world economy had adjusted successfully to the shocks of the 1970s, the sectoral shocks of 1980s did not destabilize the international financial system as a whole. As a result, there have been few signs of a generalized weakening in bank capital positions, as occurred prior to 1931.

International Cooperation

Compared to 1931, international cooperation has been substantially strengthened for ensuring the stability of the international financial system. There are several facets to this development. First, in contrast to 1931, when the newly established and poorly endowed BIS was the only public international financial agency in existence, there are now a host of such agencies: the International Monetary Fund, the World Bank and its affiliates, and various regional development banks. Each has sizable financial resources to assist stranded debtor nations by providing medium- or long-term financial assistance as well as advice on policies needed for reducing payment imbalances. Among these, the pivotal role of the International Monetary Fund cannot be overemphasized.

Second, and also in contrast to 1931, the national central banks of major industrial nations and the BIS have, since 1982, acted jointly in a timely and decisive manner to provide short-term bridge credits to strapped debtor nations pending negotiations for debt rescheduling and longer term new credits from international agencies and commercial banks.

Third, the international rescue packages of the 1980s also contained an essential element missing in 1931: the cooperation of major international commercial banks. These banks were willing to reschedule debts and extend new credits to support the debtor nations' adjustment programs for reducing payment imbalances.

Fourth, since 1974, there has been an agreement among major national central banks to carry out the lender-of-last-resort responsibility in cases where banking operations involving more than one national jurisdiction are in need of assistance.[28] Since then, the central banks have kept in close contact with one another, frequently consulting one another on the international banking situation, and, as stated, undertaken successful joint actions to provide short-term bridge credits to relieve the world debt problem.

National Safeguards

Since the 1930s, national banking systems have been made more crisis-resistant by deposit insurance, government regulation and supervision, and improved availability of information on banking operations. Although these devices may have in turn created problems of their own (such as the "moral hazard" problem involving enhanced risk-taking by financial institutions because external support is available[29]), on balance, they have strengthened national banking systems and hence indirectly the international financial system.

III. Conclusion

An analogy with the functioning of a national economy can help bring out the lessons of past international financial crises. National economic integration binds together the various regions of a nation economically and financially through unimpeded flows of goods, services and capital. While benefits accrue to the nation through greater efficiency in resource utilization, the various regions are exposed to risks of economic and financial shocks that originate from other parts of the national economy — especially since one national currency ties the regional economies together.

This does not mean, however, that nationwide banking operations are necessarily riskier. On the contrary, since not all adverse shocks are likely to affect the various regions of the nation at the same time, national asset diversification can reduce the total risk for such banks.

One type of risk, however, cannot be diversified in this manner: credit risk related to unexpectedly prolonged and severe nationwide recessions. Under these circumstances, a general deterioration in the quality of banking assets and in banks' capital positions is hard to avoid. These risks are systematic, macroeconomic risks that individual banks cannot minimize through nationwide portfolio diversification. Nor can governments contain such risk through tighter bank supervision and higher bank capital requirements. Instead, stability in the national financial system requires national authorities to conduct macroeconomic policies to minimize macroeconomic instability and to provide liquidity support to banks when macroeconomic instability results in severe financial stress.

In the global context, international banks can reduce asset risks through international portfolio diversification. Portfolio diversification, however, is not sufficient against systematic, worldwide instability that adversely affects asset quality everywhere. The likelihood of such instability is enhanced under fixed exchange rates, which tie all national economies together like regions in one nation with one national currency — but without the benefit of a single authority to ensure worldwide macroeconomic stability.

When national authorities pursue domestic objectives with little regard to their effects on the rest of the world, stresses often develop in the international monetary system that require countries with a deficit in their international payments to restrain domestic aggregate demand but provide little incentive for countries in surplus to expand it. The resultant deflationary pressure on the world economy is exacerbated if, in addition, the center country (against whose currency other nations peg their exchange rates) itself follows a deflationary policy in order to combat inflation or to maintain an overvalued national currency. Where prices and wages are not perfectly flexible, a worldwide deflation will result and lead to worldwide declines in aggregate demand, with widespread business failures and unemployment. As economic conditions worsen, the basis of the international financial system crumbles.

This sequence of events, in essence, appears to have caused the 1931 crisis. But, the world has learned much from that disaster. Flexible exchange rates have enabled the world economy to weather several major shocks since 1973. As a result, the international financial system in 1982 was in a much sounder condition than in 1931, and thus was able to absorb major disturbances such as the Mexican-debt shock. In addition, the world community also has learned to formulate and carry out a coordinated international strategy to contain the LDC-debt problem in a timely and decisive manner. Thus far, the strategy appears to have worked with considerable success.

Nevertheless, keeping the LDC-debt problem in check does not mean the problem has been solved. A number of debtor nations continue to have difficulty servicing their external debts. Capital flights from these nations as well as the virtual cessation of voluntary international private lending have put these nations in a crushing liquidity squeeze. More recently, the precipitous decline of oil prices, while providing a welcome relief to most debtor nations, has meant a sharp setback to the debt-servicing capacity of oil exporting nations. More difficult debt negotiations can be expected to lie ahead, and innovative initiatives are needed to help resolve the international debt problem that continues to threaten the long-run stability of the international financial system.[30]

It would be short-sighted to regard the LDC-debt problem as the only threat to the stability of the present international financial system. Numerous innovations in telecommunication technology have made world capital markets more highly integrated than ever before. Also unprecedented is the domination of exchange rate changes by international capital flows. In the meantime, large international payments imbalances continue despite wide swings in exchange rates. As a result, national governments have been concerned about the volatility of exchange rates and the lack of policy coordination among major industrial countries. Uncertainty hangs over what these might mean for the stability of the world economy since flexible exchange rates cannot be a panacea against all world economic shocks.

In short, during the half-century between 1931 and 1982, the world has made significant progress in buttressing the international financial system to keep problems such as LDC debt in check. By comparing the experience of the 1930s and the current international debt situation, this study helps identify the key elements of this progress on which the solutions to future international financial problems can build.

FOOTNOTES

1. League of Nations, *World Economic Survey, 1931-32* (Geneva, 1932), chart inset between pp. 64 and 65.

2. Except Spain, Iran, and Turkey. Leland B. Yeager, *International Monetary Relations: Theory, History and Policy* (Harper and Row, 1976), pp. 338-39.

3. Ninety-eight percent of the £1.7 billion total debt defaults outstanding at the end of 1930 was attributable to the Soviet Union alone, according to the Council of the Corporation of Foreign Bondholders, *The Problem of International Investment,* a report by a Study Group of the Royal Institute of International Affairs (Oxford University Press, 1937), p. 299.

4. "Until the late spring of 1931, . . . the gold standard was still intact in Western Europe and the United States. Steadiness or slight increases in seasonally adjusted figures of industrial production in Germany and the United States even offered some hope during the first few months of the year. In Great Britain and most other countries, however, economic activity kept on sinking." Yeager, *op. cit.*, p. 339.

5. Based on data in League of Nations, *Commercial Banks, 1925-1933,* Geneva, 1934, Appendix I, pp. 48-49. For Chile and Peru, the changes were from 1926.

6. The League of Nations study cites actual cases of major banks in Berlin, Vienna, Italy, and Hungary extending large new credits to industrial concerns or on agricultural bills for the sake of assisting customers in distress. League of Nations, *op. cit.*, pp. 16-17.

7. Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States, 1867-1960* (Princeton University Press, 1963), pp. 308-15.

8. The Bank of England's secret rescue of the failing William Deacon's Bank in Lancashire in 1928-30, costing the Bank of England £3.2 million, is described in R. S. Sayers, *The Bank of England, 1891-1944* (Cambridge University Press, 1976), pp. 253-59. The Bank of Italy and the Bank of England's joint rescue of the Banca Italo-Britannica of Milan in 1929-30 is discussed in Sayers, *op. cit.*, pp. 259-63.

9. The Credit-Anstalt case, the spread of international financial crisis throughout Europe, and the collapse of the international financial system are described in a large number of sources, notably, Yeager, *op. cit.*, pp. 339-49; League of Nations, *Commercial Banks, 1925-1933,* cited above; Charles P. Kindleberger, *The World in Depression, 1929-1939* (University of California Press, 1973); Stephen V.O. Clarke, *Central Bank Cooperation, 1924-31 (Federal Reserve Bank of New York, 1967).*

10. League of Nations, *World Economic Survey, 1931-32* (Geneva, 1932), pp. 319-22.

11. *The Problem of International Investment, op. cit,* p. 325.

12. U.S. Department of Commerce, *World Economic Review, 1933* (Washington, D.C., 1934), p. 278.

13. However, not all bankers and central bankers were oblivious to the precariousness of situation. In January 1931, a U.S. investment banker told the U.S. Ambassador in Berlin that "short loans to Germany were now in such volume that they could not be called or renewals refused without great danger to the financial situation in the United States." A month later, the President of the Reichsbank sent to the U.S. Ambassador a memo detailing the weakness of Germany's short-term financial position and suggesting, among other things, a long-term loan of $350-475 million to refund Germany's short-term liabilities. The Ambassador duly passed the information and the proposal to Washington, but solicited no response. Clarke, *op. cit.*, pp. 177-78.

14. *The Problem of International Investment, op. cit.*, p. 223.

15. Lester V. Chandler, *America's Greatest Depression, 1929-41* (Harper and Row, 1970), p. 98.

16. Kindleberger, *op. cit.*, pp. 97-100.

17. Yeager, *op. cit.*, pp. 346-47.

18. Kindleberger, *op. cit.*, pp. 180-181.

19. Clarke, *op. cit.*, p. 147.

20. For instance, the Federal Reserve Bank of New York did not know the extent of the foreign liabilities of banks in Austria, Germany and Britain until these countries were in crisis. Clarke, *op. cit.*, p. 185.

21. For instance, it was estimated that foreign commercial banks held 44 percent of the total deposits of the big Berlin banks in 1929. League of Nations, *op. cit.*, pp. 110-111.

22. In the Austrian crisis, the three-week delay in securing the first $14 million credit to the Austrian National Bank was due mainly to the difficulty in negotiating a standstill agreement among the Credit-Anstalt's principal creditors in Berlin, London, New York, and Paris. The foreign creditors formed an Austrian Creditanstalt International Committee to negotiate with the Austrian Government. While negotiations were going on, large fund withdrawals continued. A standstill agreement was not reached until the end of August, after the Government had already instituted exchange controls, so that the agreement achieved no more than the institution of an orderly procedure for liquidating the blocked foreign balances. The German case was similar in that a standstill agreement was not reached until August 1931, also after exchange controls had already been put in place. League of Nations, *op. cit.*, p. 58.

It appears that only in the British crisis did the large international banks agree to extend credit to a besieged foreign central bank. In that case, a $200 million loan by a group of New York banks headed by J.P. Morgan & Co. was extended to the Bank of England on August 28, 1931, and another $200 million was raised in Paris. The loans, however, proved inadequate for meeting the final assault on sterling. Clarke, *op. cit.*, 209-213.

23. Clarke, *op. cit.*, p. 210 and p. 263, especially note 97.

24. The LDC-debt data are from Morgan Guaranty Trust Company, *World Financial Markets*, February 1983, p. 5; the World Bank, *World Debt Tables, 1984-85,* Washington, D.C., 1985, p. ix. U.S. bank lending data are from Federal Financial Institutions Examination Council, *Statistical Release* E16, June 1, 1983; and Federal Reserve Chairman Paul Volcker's statement before the House Foreign Affairs Committee, August 8, 1984, Appendix Table 3.

25. Maxwell Watson, Peter Keller, and Donald Mathieson, *International Capital Markets: Developments and Prospects, 1984,* International Monetary Fund Occasional Paper No. 31, Washington, D.C., 1984, p. 5.

26. The World Bank, *op. cit.*, pp. xvi-xvii.

27. Federal Deposit Insurance Corporation, *Annual Report, 1984* (Washington, D.C., 1985).

28. Federal Reserve Governor Henry Wallich's testimony before the Permanent Subcommittee on Investigations, Senate Committee of Government Operations, *Federal Reserve Bulletin,* November 1974, pp. 760-62.

29. Michael C. Keeley and Frederick T. Furlong, "Bank Regulation and the Public Interest", *Economic Review,* Federal Reserve Bank of San Francisco, Spring 1986, pp. 55-71.

30. In this regard, the Baker Plan for aiding the debtor nations in making structural adjustments for improving their economic conditions is a significant step in the right direction. See Hang-Sheng Cheng, "The Baker Plan", Federal Reserve Bank of San Francisco, *Weekly Letter,* November 22, 1985.