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INTERNATIONAL AND TRANSNATIONAL FINANCIAL RELATIONS

by

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INTERNATIONAL AND TRANSNATIONAL FINANCIAL RELATIONS

1. My generation, and the one or two generations preceding mine, were brought up in a world of international relations. A world, that is to say, where the State had acquired a monopoly of foreign relations. The monopoly of course was not a complete one. Transnational relations went on all the time, but the world I am referring to was used to considering as a natural state of affairs a pyramid of power at the top of which stood the State. Transnational relations took place but were subject to the approval or were even planned by the State at government or specialized agency level.

Still, if we lengthen our historical perspective somewhat, we can immediately see that this pyramid of power which culminated with the State, had not been the normal state of affairs for more than one century. Scholars with a more developed sense of history knew this very well. However, they thought that an irreversible process had been set in motion, and that the monopoly of the state over foreign relations would inevitably increase as time pressed. The drive to internationalize transnational relations was considered irreversible.

The decades which have followed the Second World War have witnessed, however, the opposite phenomenon. The drive to internationalization has been, at least for what concerns the large industrial countries, firmly reversed and an opposite process of transnationalization has started again. It has proceeded unabated for more than three decades. It has been so strong that a generation younger than mine has come to consider it as irreversible as we had considered internationalization.

The events of the last five years, however, have made this prospect much less certain. I think that we are at a cross-road. We can expect, for the next decade, a reassertion of international relations and we can, equally reaonably, expect a renewed process of transnationalization. I favour the first outcome as the most likely, and I will do my best to explain why I think so focussing on the subject I know best, which is international banking.

First of all, however, I will describe the transnationalization of world banking which has occurred since the nineteen sixties, and which has involved, more and more heavily, the main banks of the large industrial countries.

As I have said before, the 60 years preceding the Second World War had seen the opposite process take wing. Banks had been asked, induced, even urged, by States to organize a network of foreign operations. The history of foreign banking in Italy since the unification of the country in 1860 is an extremely good example. French banks, and in particular the Credit Mobilier, had been asked by the French Government, also at the insistence of the Italian Government, to start operations in Italy. This happened in the 1860s and 1870s. After the crash of the Italian banking system in the 1880s, the Italian Government asked the German Government to persuade the large German banks to start operations in Italy, which happened in the 1890s. German large banks and the Deutsche Bank in particular, had been created by the Imperial Reich anyway, set up with the declaredly mercantilistic objective of furthering German trade and German power.

The drive to make banks an important instrument of foreign policy was so powerful in the decades before the First World War, that it involved even Britain. Britain had been a very remarkable case of

transnationalism, with the power of the city of London being much greater than that of the State.

British financial institutions, especially the most traditional ones, the merchant banks and the Bank of England, had identified their private gains with the interests of the British nation at large. They had pushed for free trade and free international financial relations even when the best interest of Britain would have required something radically different.

However, as the European powers, and the German Reich in particular, had started to entertain global policy objectives in the two decades before the First World War, British bankers had begun to experience heavier pressure to help her Majesty's Government in the enforcement of its foreign policy objectives. Their faith in transnationalism was so strong, however, that only in a few cases the Government had been able to persuade them to become an economic arm of British foreign policy. To this day, I may add, the transnationalization of British banks has remained unabashed and the precipitous decline of the British economy can be, and has been, attributed to the continuous capacity, on the part of the British financial institutions, to impose on the Government their view, that in a nutshell consists in thinking that banking serves the purpose of sending money wherever in the world there is the most profitable chance of investing it. And that British national interest can only coincide with the profit maximizing activities of the city of London.

After the First World War, the two inter-war decades have witnessed the strongest affirmation of the international model of foreign relations that the world has ever experienced. The monopoly of the State over foreign relations has been extended to include, for the first time, all sorts of fields which would have never occurred to a

statesman like Bismarck to include. This has meant that financial relations and foreign banking operations were subjected to State supervision in order to make them more and more an instrument of the foreign policy objectives of the State. This was a direct consequence of the economic facets of the concept of total war, a concept that emerged and was practised on a large scale only during the First World War.

A partial exception to this tendency was represented by the drive to establish foreign operations experienced in the first half of this period by large American banks. Because of the peculiar distribution of power in American society, this drive can be seen as an experiment in transnationalism. But it could equally well be seen as another case of the prevalence of the international model of foreign relations in the inter-war period. I think both models apply in this case - U.S. banks had genuine profit-maximization in mind when they sought to establish foreign operations. They would have done it even in the face of the Government. But it was also the case that the U.S. Government had a continuous strategy to wrest the primacy in foreign relations away from Britain and recognized the importance of the foreign operations of U.S. banks to accomplish this strategy.

In the event, however, the transnational model can be said to have prevailed in the twenties with American banks overstretching themselves in foreign operations and in sovereign lending in particular, and then withdrawing from foreign lending to speculate on Wall Street or to lend to Wall Street speculators at the end of the decade. This sudden withdrawal from foreign lending cannot in any way be considered an act of foreign policy conceived by the U.S. Government. It occurred in the pursuit of profit maximization and it had consequences which in no way can be said to have been beneficial to the exercise of foreign policy on the part of the United States.

The crisis of 1929 and the European banking panic of 1931, followed by the U.S. panics of 1932 and 1933 were a direct result of the prevalence of unfettered transnationalism on the part of U.S. banks.

Transnationalism, by definition, must be the pursuit of a micro-goal, either economic or political, by a non-State political-economic agent in the world arena. American banks when they lent greater and greater sums abroad and floated an avalanche of foreign bonds on the U.S. market had mostly their balance sheets and their market share in mind. The same goals motivated them when they abruptly retracted from the world market at the end of the twenties. There just was more money to be made lending to Wall Street brokers than to German cities or Latin American Governments.

The transnational behaviour of American banks in the twenties can be said to have made the move to a completely international model of foreign relations more inevitable in the 1930s for the world as a whole, including the United States. More than that, they can be said to have done more than any other force to bring about the realization, in most countries, of wide State controls over the functioning of the domestic economic systems. State control over the economy had become extensive during the First World War. But, at the end of the conflict, most people, in most countries, had shown a desire to see less of that. The transnational behaviour of the U.S. banks in the twenties, and the world chaos and depression which it caused, rendered the possibility of a return to laisser faire totally anachronistic and legitimized Keynesianism in England, the New Deal in the U.S. and the totalitarian control of the economy in Germany, Italy and Japan. As a result of the world crisis, Mussolini switched from liberalism, which had characterized his first decade in power, to more and more intense dirigism and protectionism.

In the United States, as well as in other industrial countries, laws were passed in the 1930s to reform the banking system which were uniformly inspired by the consciousness that banks, if left to behave freely, would sooner or later induce a financial crisis and would have to be rescued, as they had been at the beginning of the 1930s. This possibility was exorcised by extensive banking regulation, which reached its acme in the United States. It is worth noting that the only country where financial institutions escaped regulation in the 1930s was Great Britain. This is another example of the City's masterly control of British politics. All the critics of banks in Britain got in the 1930s was the Macmillan Report, which anyway ended up by attributing torts to both banks and industry.

2. The banking reforms of the Roosevelt years effectively segmented the United States financial market and left the large "money center" banks without much prospect for growth. Ironically, the only field that remained open to them to plough was that of foreign operations, which was the one where their actions had been most destabilising for the world economy. Throughout the second half of the 1930s, and the war years, the U.S. large banks experienced an enormous inflow of foreign deposits, owned by people who fled a Europe ridden by war and totalitarian regimes. This helped the large U.S. banks considerably, as they had been effectively cut off from the U.S. inter-bank deposit market by the flood of war-bonds floated by the U.S. Government to finance the War, which were absorbed by provincial banks and other financial institutions.

At the end of the War, foreign operations being the only growth prospect open to U.S. large banks, they had to make sure that the world financial system would be reconstructed in a way that made

the realization of those prospects possible. U.S. large banks thus fought a stubborn and in the end successful battle against people like Keynes and Harry Dexter White, who had very different plans for the world financial system.

They sought to reorganize the latter according to a clear model of international financial relations, where private short-term capital movements could be free to help, but prevented from harming the growth of national economies. The original Keynes and White plans had provisions for full control of unwanted capital flows.

The final plan for the establishment of the International Monetary Fund, however, after the U.S. banks had exercised their influence, turned out to be very different. There was in it no clause compelling receiving countries to return short-term capital flows to the countries whence they came. There was no provision for an international Central Bank, which would be able to create public international liquidity and distribute it among countries. Thus, with the darkening of détente prospects in Europe and the start of the cold war, a new flood of money invaded the U.S. directed mainly to the large banks, of course, as Europeans tried to remove at least their money from countries which could become communist any day. The Marshall Plan was launched to balance this flow with one in the opposite direction. The same result, of course, would have been obtained if the appropriate clauses contained in the Keynes and White Plans had been maintained. But those would have put an automatic system into action whereby the funds would simply be returned to the countries of origin. The Marshall Plan was, on the contrary, a system of aid, tied to the purchase of U.S. made goods. It was an immensely successful operation, which had a huge propaganda effect in Europe, helped U.S. industry and agriculture and solved the world's payments problem in those crucial years.

Thus a compromise was found by which the foreign economic policy of the U.S. could be kept within the international model and U.S. large banks were left free to manage their transnational model of foreign financial operations.

The powerful drive to increase foreign operations came to large U.S. banks from the static situation of the U.S. domestic money market. Large banks are the principal source of credit of large U.S. corporations, and, like other large banks in the main industrial countries, can usually lend more than they are able to get as deposits from the public through their branch network. The huge presence of U.S. Government bonds and the banking reforms of the Roosevelt years prevented them, however, from making up their deficit of loanable funds on the U.S. interbank market. The stifling regulatory environment also prevented them from competing for funds by bidding up the deposit rate they gave their customers.

While in the late 1930s, 1940s and early 1950s, foreign deposits had been an extremely important source of loanable funds for large U.S. banks, this source dried up with political and economic stabilization in Europe. The main source of dynamism then becomes, in the early 1960s, the enormous wave of U.S. investments abroad, which had Europe as its centre.

We have now almost forgotten that the late 1950s and early 60s were in the United States years of industrial maturity and stagnation. The phase of growth based on automobiles, motorways, and consumer durables had come to its limit. With the dollar remaining high-valued, but every day nearer to a devaluation, with a progressive government coming into power under John Kennedy, there were powerful incentives for U.S. capital to emigrate, especially to Europe. There, markets were ready for automobiles and consumer durables, and investment was cheap.

American large banks were ready to follow large U.S. corporations in their drive to multinationalize. A renewed battle for market shares soon broke out as large banks competed for those corporations' international deposits. Both banks and multinational corporations soon discovered that a very lucrative game could be played, by engaging in one-way speculation against currencies which were tied to parities fixed under the Bretton Woods system. Central banks had to defend these parities, and speculators could not lose.

The Kennedy-Johnson years were thus characterized by massive migration of American capital abroad, and by repeated and powerful attacks against the dollar parity, mounted by the treasurers of American multinationals with the indispensable help of the large American banks. So powerful were those speculative attacks that they induced a series of measures by the American Government, aimed at restricting the freedom of capital movements. These measures however, were adopted always trying to get the highest possible measure of approval from bankers, i.e., from the very people against whom they should have been aimed. They inevitably achieved results which provided no solution to the problem, but only managed to shift the problem itself to another dimension.

I shall analyse one of the most important examples of this behaviour in one minute. Before that, however, it is worth pausing to ask why the U.S. Government acted so feebly. The most obvious answer is that large banks and multinational corporations are powerful pressure groups, whose open enmity cannot be endured for too long even by an Administration with massive popular backing. But there is another answer. The Government of the United States, like that of other large industrial countries, has got used to furthering its foreign policy objectives through the actions of large banks and multinationals. The Government, that is to say, strives to work with a traditional inter-

national model of foreign relations by demanding, from time to time, that those transnational actors, large banks and corporations, adopt certain types of behaviour, which help the American foreign policy stance vis-à-vis certain countries. If the Government adopted at the same time measures directly punitive towards large banks and companies it could not ask them to help the conduct of American foreign policy by their collaborative action. Hence the inconsistent behaviour of the Democratic Administrations with respect to the problem of international financial speculation.

A good example of this inconsistency is provided by the Voluntary Credit Restraint Program, adopted in 1965. This constrained foreign lending from the home offices of U.S. banks. Up to then U.S. banks had lent abroad directly from the U.S., thus posing increasing problems for the U.S. balance of payments. As a result of the V.C.R. program, banks were allowed to lend abroad funds which they had acquired through their foreign branches.

After the Suez crisis of 1956, British banks had been subjected to similar constraints. However, the restrictions extended to all financing of non-British customers with sterling denominated loans. British banks had reacted by attracting dollar-denominated foreign deposits, thus giving impetus to the Euro-dollar market.

The American VCR program, however, did not prevent American banks from lending abroad in dollars. It only prevented them from lending abroad from their U.S. balance sheets. As a result, American banks began a massive drive to open foreign branches. In some cases these were genuine foreign branches, collecting genuine foreign dollar deposits. But in a large number of cases the opening of a foreign branch only meant that the home office of an American bank would open a "shell" in an offshore centre, like the Bahamas, and start a Bahamas

balance sheet in New York. On the liability side of this balance sheet the bank would put all deposits it received from sources outside the U.S., on the asset side it would put loans and other investments. Thus the bank would run in New York two balance sheets, side by side. One, of its U.S. operations, subject to U.S. banking regulations and to U.S. taxes. The other, of its "Bahamas operations", subject only to Bahamas fiscal, legal and banking requirements, which were very close to non-existence.

By the VCR program, the U.S. Government had thus renounced its sovereignty on a large share of total financial transactions taking place in New York and other U.S. money centres and involving mostly, if not exclusively, American citizens and American Banks.

This solution, moreover, not only posed sovereignty problems. It also did not facilitate the conduct of U.S. monetary policy. In 1969, for instance, when the U.S. Government tried to stem the inflationary impact of the Vietnam War on the U.S. economy by a restrictive monetary policy, U.S. banks reacted by borrowing massively from their "foreign" balance sheets. There were, in fact, no rules to prevent banks from borrowing from their "foreign" offices.

Thus, about 14 billion dollars were passed from the foreign to the domestic balance sheets of U.S. large banks and lent to large U.S. corporations. This prolonged the tight money period in the U.S., as the Fed had to depress housing and other sectors in order to balance the refusal by large corporations to accept the credit squeeze in the way we have mentioned. The Fed tried to remedy the situation by imposing a 10% marginal reserve requirement on additional borrowing from foreign branches. But it also recognised that the large banks had enjoyed an unfair advantage and allowed more and more U.S. banks to open "shell" branches.

The year after, 1970, the American credit market slumped and large funds were shifted back to the "foreign" balance sheets of U.S. banks. Those funds were used to speculate against the dollar, as foreign banks borrowed Euro-dollars from U.S. banks' "foreign" branches and transformed them into other currencies. As is known, under the pressure of these speculative attacks, the dollar was devalued in 1971. Most large industrial countries then decided to impose exchange restrictions. But those restrictions were easily by-passed. The foreign branches of U.S. banks borrowed foreign currency deposits in the international inter-bank market, which was not subject to exchange controls, and re-loaned the funds to speculators who could not acquire the funds directly from European banks. They also swapped balances for customers who could not get funds out of their countries, and helped those customers who could not get funds into their countries by selling deposits to the domestic inter-bank market or by acquiring deposits from domestic banks. As a result, dollars again flowed into the coffers of European Central Banks, in spite of their exchange controls. The dollar had again to be devalued, under the pressure of speculation, in 1973.

In 1973 there was a real explosion of the foreign branch activities of U.S. banks. Their assets rose by 56% while the number of foreign banks, finance, and leasing affiliates owned by U.S. banks rose from 416 in 1971 to 1670 companies in 1973.

This-over extension could not fail to have traumatic effects. These occurred in 1974 with the secondary banking crisis in Great Britain, the Herstatt and Franklin National Bank failures in Germany and in the United States.

In the U.S. recession of 1975, $20 billion were again shifted from the "home" to "foreign" balance sheets of U.S. banks.

This prevented U.S. interest rates from falling and prolonged the U.S. recession. It also undoubtedly strengthened the downward pressure on the dollar exchange rate. Where did the money go this time? It went to solve the balance of payments problems of countries which were struggling with giant oil deficits.

3. The drive to transnational banking I have sketched above started in the United States as a way for the largest U.S. banks of getting round very dim growth prospects at home. As a result of the excesses of the 1920s, to which I have also referred above, in the 1930s, extensive regulation of banking took place in the major industrial countries and particularly in the U.S. Regulation was so devised as to considerably restrict the field of domestic operations of large banks, particularly of U.S. large banks. Ironically, the only field where they were left free to expand was the international field and large banks were busy, even in the late 30s, attracting foreign deposits. They were also extremely interested, and successful, in making sure that the world financial system be rebuilt in a way which would permit transnational financial operations to take place on a large scale. The alternative model of rebuilding the world financial system according to a purely international model of financial relations, sponsored by Keynes and White, was discarded.

As the long post-war boom extended from the midfifties into the sixties and early seventies, large banks all over the developed world were induced, with the help of national authorities, to expand their transnational operations.

The international inter-bank market, for instance, was developed, in the early sixties, to dump dollars which European countries saw

accumulating in their official reserves in the long era of dollar semi-inconvertibility, which lasted over a decade. Large European and Japanese banks were given very attractive swap contracts by their central banks, so that they could dump dollars on the interbank market without running the currency risk, which was picked up by the Central banks. Foreign operations of large banks were also favoured by European and Japanese authorities as a way to return to large banks part of the competitive edge taken away by restrictive banking regulation.

Regulation had, in fact, diminished the large banks' capacity to grow, but the long post-war boom had induced the fast growth of large industrial corporations, the traditional clients of large banks. Industrial giants like Siemens, G.M., Mitsubishi, Fiat, Saint Gobain, could not solve the problem by getting the finance, which they needed to operate, from smaller banks. This could be done to some extent, but industrial credit on a large scale can only efficiently come from large banks. The problem of the relative size of lender and borrower is just one of the problems involved.

As a result, as I have mentioned above, the growth of transnational banking was favoured by national authorities, who, at the same time, however, started to become more and more painfully aware of the loss of control and stability for world economic relations that this involved.

With a decade of dollar devaluation, in the 1970s, the transnational operations of non-American large banks were naturally favoured. European and Japanese banking is a very concentrated business, and the strength of those countries' currencies added competitive power to these giants in the transnational market. Today, the relative share of the total transnational banking market held by U.S. banks is much smaller than what it was 15 years ago. But, since we

are speaking of a very small total number of giant banks, this loss of relative weight on the part of U.S. banks has decreased, rather than increased, the relative stability of the world financial system. It has meant that the powers of the Federal Reserve to control the market have decreased, and that, at the same time, the free-riding tendencies of the largest corporations, and of American banks in particular, have increased. The market has become too large for any one Central bank to control it just by disciplining its own national banks. At the same time, the dollar component of the market has increased rather than declined because of the new strength of the dollar in the 1980s. Thus, while the Fed is too small to control the market, other central banks do not have the liquidity creating capacity that is required to do so, as each currency other than the dollar represents only a small part of the market. However, since such a large portion of the market is in dollars, American domestic economic and financial events exercise a disproportionate influence over it, and since economic policy making in the U.S. has acquired a highly uncertain and oscillatory nature, these oscillations reberberate through the transnational financial market with effects which cannot but frighten the observer.

The increasing heterogeneity of transnational finance also leads to highly differentiated behaviour. American large banks, facing a very competitive environment at home, and the perpetual need to look after their shares performance on Wall Street by showing good balance sheets every quarter, tend to behave very differently from continental European banks, which do not have such problems. Since international lending has become very regionalised, with U.S. banks specializing in Latin American loans and German banks in Eastern Bloc loans, while Japanese banks prevail on the Pacific Basin, the behaviour of the banks of the leading regional nation prevails in the management of loans to that region. In the Polish debt crisis for instance, German banks conducted the negotiations with the aim of not forcing Poland

into a desperate corner. They were allowed by German Law to make almost unlimited, tax deductible provisions for those debts, and they had to protect an enormous flow of German trade to Eastern Europe. German share holders, moreover, traditionally react in a very positive way to a bank making itself as strong as possible, as they are less dividend minded than the institutional investors who prevail in the U.S. As a result, and in spite of the more militant stand taken by U.S. banks, the Polish debt crisis, and in general the Eastern European debt crisis, has been very effectively defused. German prestige in the area has consequently risen so high that it has taken the combined efforts of the Soviet Union and of the United States to prevent a very remarkable rapprochement between Germany, the GDR, Bulgaria, Roumania and Hungary.

Things have been very different in Latin America, where U.S. and British banks lead traditionally. In this area we have noticed a much tougher stand being taken by creditors. European and Japanese banks have tended here to toe the line set by U.S. banks. This tougher stance must be seen in the context of the domestic American banking situation. U.S. main lenders to Latin America are four or five large U.S. banks, and some of them are very keen to unblock funds to invest them in the U.S. consumer credit market, where recent deregulation has increased their competitive powers. In addition, and this is a consideration of general value, recent and not so recent events, like the troubles of Franklin National, Chrysler, Continental Illinois, have shown in the last ten years that if the troubles of a company are large enough, and the company is large enough that its failure would disturb the U.S. financial market, the American authorities will go to the rescue, and use public money to solve private problems. But these rescue operations cannot be programmed. They have to take place at

the last minute, just before the situation becomes explosive, otherwise the U.S. public might not be frightened and agree to the use of vast sums of public money which are involved.

Of course, going every time to the edge involves the risk that one may eventually go over the edge. But these are the very risks involved in extensive transnationalization of international financial relations. It carries with it the problem that microeconomic behaviour, perverted by the hope of being rescued if real distress occurs, will induce imbalances too serious for the system to bear without breaking up.

Since these considerations are made not only by a humble economist like me, but also by the financial authorities of Europe and Japan, and by a number of influential law-makers, economists and financiers in the U.S., one can very clearly detect a rather desperate attempt to revert from the transnational model of financial relations to the international one to as wide an extent as possible and before a conflagration of major dimension occurs.

If this conflagration, however, occurs, the transition to the international model will be immediate and total.

These are the reasons why I said at the start that I think the pendulum will swing back to international relations. It was an Italian, Giovanbattista Vico, who invented cyclical history. You will allow an infinitely humbler Italian to walk in his giant shadow.

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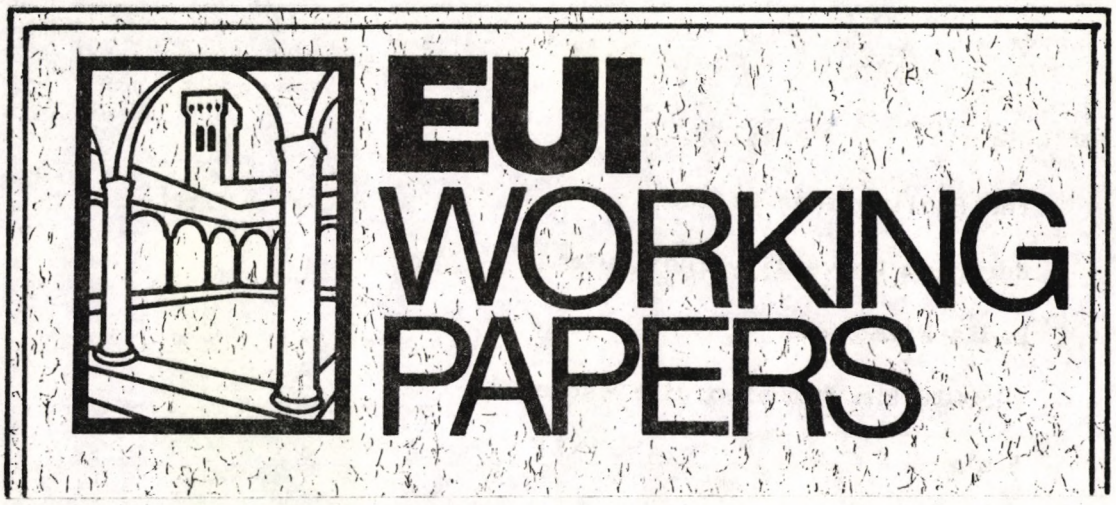

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